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DOES FEDERAL ACCOUNTING AND AUDITING NEED OVERHAULING?

JOSEPH P. HARRIS

IT GOES without saying that the Federal government because of the huge size of its annual budget needs to utilize the most approved, modern, and scientific systems of accounting, financial reporting, and auditing. Methods which were reasonably satisfactory years ago when expenditures were relatively small may be wholly inadequate today. Nothing short of the very best in organization and methods of fiscal management should be permitted in a government which spends nine billions of dollars annually, or about one-eighth of the national income.

The present financial administration of the Federal government was subject to strong criticism in the reports of the committees of Congress and the President on government reorganization in 1937. The President's Committee on Administrative Management and the Brookings Institution in its studies for the Congressional committees each criticized the Bureau of the Budget for failure to develop an adequate staff. Both reports recommended that the Bureau staff should be increased and strengthened, that the Bureau should develop a management research division to investigate constantly the organization and administrative methods of the government. This function, which was specifically assigned to the Bureau by the Budget and Accounting Act of 1921, had never been carried out because of the policy of the Bureau to set an example of economy by the parsimony of its own expenditures. The Bureau of the Budget has operated on a budget so small in proportion to the total budget of the Federal government that it has not been able to investigate adequately the departmental estimates and work programs, and to perform adequately other functions normally assigned to a central budget agency. In 1936 its budget was only $180,000!

The recommendations for the development of the Bureau of the Budget are being carried out without any fuss or feathers. Starting in 1937, its appropriations have been increased threefold by Congress. The Bureau has been moved from the Treasury, where it occupied a semi-independent status since 1921, to the Executive Office directly under the President, and has been given broader functions as a managerial agency aiding the President. It has been reorganized internally, and is rapidly building up a strong staff.

While these recommendations for improved budgeting are being carried out, the recommendations of the President's Committee on Administrative Management relating to accounting and auditing have not been adopted. These recommendations, it will be recalled, were that the Comptroller General should be superseded by an officer to be known as Auditor General, whose functions would be confined to

auditing and reporting to Congress; that a joint Congressional committee on public accounts be created to receive and act upon these audit reports; and that the accounting and "control" functions of the Comptroller General should be transferred to the Treasury or to the Bureau of the Budget to be carried out by an officer responsible to the President. The committee criticized the present conduct of accounting and auditing in the Federal government, and recommended these changes in organization with the thought that they would pave the way for needed improvements. Its proposals were seriously opposed on the ground that they would vest too much authority over expenditures in the hands of the Executive at the expense of Congress. In the confusion of the controversy involving the details of preaudit and postaudit and the procedural aspects of the present system, few persons in Congress or outside really understood the issues which were controverted. This part of the administrative management program, however, occupied most of the time of the Congressional committees, and after the proposed changes were understood by the Senate and House committees, were approved with modifications, and were reported out and passed in both houses, but finally went down to defeat with the Reorganization Bill of 1938. The following year, when the 1939 Reorganization Bill was taken up and passed by Congress, all controversial features were dropped, and no further attempt was made to bring up the accounting and auditing features.

The issue, it may be safely said, is not closed, and will not be so long as the existing and accounting and auditing system of the Federal government is subject to the following serious criticisms: (1) That the accounting system, despite notable improvements in parts, is, by and large, not up-to-date, lacks desirable uniformity, and does not provide essential information concerning the financial conditions of the government for the use of executive officers, the President, the Bureau of the Budget and Congress; (2) that the present system of audit is seriously defective; (3) that Congress is inadequately provided with information on financial operations and practices; (4) that the rulings of the Comptroller General unduly hamper administration; (5) that there is a failure to distinguish between accounting and auditing; and (6) that Congress is not organized to receive and act upon audit reports.

When Congress enacted the Budget and Accounting Act in 1921, a major purpose was to establish a modern accounting and auditing system. This was stated in the Report of the Senate Committee on a National Budget System as follows:

> The Government has become notorious for lack of uniformity in its accounting methods. . . . The actual effect of enactment of the bill would be to remove many hampering restrictions which now inhere in the accounting laws and which serve only to surround Government account procedures with endless red tape. . . . Existing accounting procedure in the Government practically follow the specifications laid down by Alexander Hamilton, who was the designer and author of the original Federal accounting system. While methods in the commercial world, where executives have been given a free hand, have steadily improved, and continue to improve, the Government's accounting system remains practically as it was originally put into effect, hemmed in on all sides by statutory limitations and age-old traditions. It is believed that the provisions of the committee bill will go far toward breaking down these limitations and will result in putting the accounting and auditing work of the government upon a modern basis.

A second major purpose of the accounting and auditing provision was to provide Congress with adequate reports on the financial operations of the Government, and thus enable it to hold executive officers to a strict accountability. Mr. Good, Chairman of the House Committee, pointed out in the hearings that

> Congress is the body that appropriates the money and yet it exercises no control over the expenditure of appropriations. . . . Congress is left absolutely helpless to know, first, whether the appropriation is being expended for the purpose for which it is appropriated, and, second, whether the accounts are properly audited.

It is now apparent after 18 years of operation that the Budget and Accounting Act of 1921 has not accomplished the objectives for which it was designed. The accounting system of the Government is today more complicated, less uniform, and more surrounded by "hampering restrictions" and "red tape" than it was in 1920. It is the purpose of this article to review some of the principal criticisms of the existing accounting and auditing of the Federal government, with particular attention to the needs of management, and to discuss needed improvements and the proposed changes in organization.

DEFECTS IN THE EXISTING ACCOUNTING SYSTEM

The Senate Committee in 1921 expected that the defects which it found in the accounting system, would be corrected by giving the Comptroller General authority to prescribe administrative accounting methods. This expectation has not been realized. Thirteen years later, in 1934, the special committee on Federal expenditures of the United States Chamber of Commerce reported that "the accounting methods used by the government have long been criticized," and went on to recommend that "there should be a complete reorganization of the accounting system."

While the accounting system of the Federal government has frequently been criticized because of the lack of uniformity, it is universally recognized that a centralized system would be undesirable and impracticable. The detailed accounting records must necessarily be maintained by the operating agencies, so that the information will be readily available to the executive officers, and a considerable degree of variation is necessary to meet the varying needs and conditions in an organization so vast in size and carrying on such diverse activities. The present practice, however, lacks the minimum of uniformity which is essential to the maintenance of central control records, to financial reporting, and to the provision of periodic balance sheets showing the financial condition of the government. Some departments, for example, set up as encumbrances against appropriations the entire requirements for the year, while others enter only actual obligations. Different classifications of expenditures are frequently followed in the budget, bookkeeping records and reports, and terminology and classifications are not uniform from department to department. Under the circumstances it is easy to understand why the Bureau of the Budget complains that it cannot secure the information necessary for its work. In the absence of better records, the Treasury accounts of cash transactions and the accounts showing the warrants drawn against appropriations are utilized, but these are not satisfactory for the needs of the Bureau of the Budget and the President. To a considerable extent, the accounting system of the Federal government is still maintained on a cash disbursement instead of an accrual basis.

Another defect of the existing accounting system is the absence of adequate financial reporting showing a complete and current picture of the financial condition of the government and of each of its funds and major operations. The departmental and central accounting systems lack adequate integration to provide such information. Improved reporting and more adequate central control records are essential if guesswork is to be avoided, and the financial policies of the government deter-

mined upon a factual basis. The daily Treasury statements and the annual report of the Treasury, while useful, do not pretend to present a complete financial picture of the operations of the government. Similarly, there is need for a comprehensive, meaningful annual report on the government finances, made available promptly after the close of the fiscal year. Such reports are particularly important in a vast organization such as the Federal government, and would be of value to Congress, executive officials, and the public.

It may be stated that it is impracticable in so large an organization to develop an integrated system of departmental and central accounts and current financial reporting upon the financial condition and operation of the government. The experience of the Bureau of Warrants and Accounts in the Treasury Department in setting up the accounting and reporting system covering the emergency relief expenditures is illuminating in this connection. The work relief appropriations were originally made directly to the President, and for his information in directing this huge undertaking it was necessary in 1935 to set up a system of accounting which would provide him with up-to-the minute figures, accurate in every detail. Central direction and control are placed in the Treasury Department, although the accounting officers of the Treasury have no voice whatever in any administrative matters. To provide needed flexibility and to serve local needs the accounting operations are carried on in separate state offices. Separate accounts are maintained for each of the projects, numbering over 300,000, which have been set up during the period, and are kept upon an accrual basis, as closely as it is feasible to do so, with a current preaudit of all payments. Purchases of materials and equipment are audited before the obligation is incurred.

The effectiveness of this sytem is indicated by the fact that from 1935 to the end of 1938 the Treasury accounting officers had taken exception to 145,000 items of purchase of materials and equipment prior to purchase, and to approximately 780,000 vouchers and payrolls before disbursements were made. Through prompt payment of bills the Government has saved approximately $6,000,000 in discounts. Of the $4,125,000,000 which had been settled by the General Accounting Office after a post audit, only $60,000, or less than 1½ thousandths of 1 per cent had been disallowed.

From the beginning of the work relief program, complete financial reports have been made available to the President every 10 days, and a detailed accounting, consisting of a 500-page report is made to Congress within 9 days after the beginning of each regular session covering the period up to December 31. These reports show in detail "when, how, where, and for what purposes" the relief moneys were expended. They show the status of the funds as to Presidential allocations, administrative allotments, obligations, expenditures, unobligated balance, and unliquidated obligations, and also contain comparative data.

While it is not suggested that the same system is applicable to the regular expenditures of the Government, since the work relief program presents many special and different requirements, nevertheless, this experience indicates that it would be entirely practicable to develop an accounting system which would provide the executive officers, the Bureau of the Budget, the President, and the Congress with accurate and detailed financial reports within a few days after the close of an accounting period. The usefulness of financial reports is in direct proportion to the promptness with which they are made.

The improvement of the accounting

practices of the Federal government is something which cannot be done once for all; it must be carried on continually, and is a task of great magnitude. The primary responsibility for accounting and financial reportings of the departments should be placed upon individual departments, but they should be subject to uniform requirements necessary to the maintenance of central accounts and the preparation of consolidated financial reports. There should be developed within each department or agency an accounting office, manned by trained and experienced personnel, responsible for departmental accounting. In addition, there should be a central office or division to maintain central accounts, prepare consolidated reports and equipped to render expert advisory assistance in the development of departmental accounting procedures. Such a central office, which logically belongs in the Treasury, should exercise effective leadership in the development of improved practices and systems, and should have the authority to investigate departmental accounting to appraise its adequacy and completeness, and to report thereon to the President in case recommended improvements are not put into effect.

Congress also should be supplied with information concerning the accounting practices of the several departments, particularly of any features which are unsound. For this reason, it should be the duty of the independent auditor to examine not alone the accuracy of the accounts of the departments and the legality of expenditures, but to consider as well whether the accounting procedures are in accordance with sound practices.

It may be questioned whether the provision in the existing law which authorizes the Comptroller General to prescribe accounting systems is sound. Accounting is an essential part of administration, and should be developed with primary view to the needs of administrative officers.[1] Prior to 1921 a similar power was vested in the Comptroller of the Treasury, but this officer utilized it principally to prescribe the accounts reviewed by his office, and made practically no effort to develop accounting methods within the departments. For a number of years the Comptroller General made little use of the authority, but recently it has been assigned to the Office of Investigation, a detective unit utterly unsuited to this task. More recently the services of qualified accountants have been utilized, but the function has been carried on with primary attention to bringing to the Comptroller General's office records which enable him to do his work, with less attention to the development of improved accounting practices and meeting the administrative needs of executive officers. The exercise has been one of control rather than of service, and the departments have been reluctant to seek technical assistance which might result in the establishment of accounting records and procedures unsuited to their needs. As a result there has been conflict rather than coöperation; the departments have been hampered in developing their internal accounts; and the Comptroller General has not secured the coöperation which is essential to the development of a modern accounting system.

DEFECTS OF THE PRESENT AUDIT

Auditing in the Federal government is carried on by the Comptroller General through the authority vested in him to make final settlement of all accounts and

[1] President Hoover, in 1932 in submitting an executive order to Congress (which was later set aside with all the reorganization orders at that time) transferring the function of prescribing the accounting systems from the Comptroller General to the Bureau of the Budget, stated: "It is not a proper function of an establishment created primarily for the purpose of auditing government accounts to make the necessary studies and to develop and prescribe accounting systems involving the whole field of government . . . Accounting is an essential element of effective administration, and it should be developed with the primary objective of serving this purpose."

claims. The audit is conducted not through an examination and verification of the departmental accounts, but rather through the submission of original documents covering individual transactions to the central office at Washington, where these are audited before final allowance. The Comptroller General maintains central appropriation accounts in his office against which these expenditures are checked. The audit is thus a long-distance paper audit of individual transactions rather than the departmental accounts. The Comptroller General has been able over the years to require an increasing body of original documents to flow into his office for this purpurpose, many of which are permanently filed there.

An audit to be of greatest value must be conducted in the operating agencies, where original bookkeeping records are available, and where administrative accounting officials can readily be consulted to clear up any doubtful points. The observations which auditors can make only on the scene of administrative operations, which are an essential element of an audit, are now almost wholly lacking. The clerks in the General Accounting Office at Washington are helpless if the papers submitted are regular on their face. At present all questions have to be cleared up by voluminous correspondence between the departments and the General Accounting Office. The departments have found it necessary to maintain detailed central records duplicating those kept in regional and field offices, in order to supply any information which the Comptroller General may demand. This is not only expensive, but it is also highly inefficient and unsatisfactory. If the audit were made in the operating agencies, questions could not only be answered immediately, but the auditors would be able to make much more exact and discriminating inquiries.

Another defect of the existing audit is the fact that it is months delinquent. Except for the relatively few payments which are preaudited, and the emergency work relief accounts, which are handled promptly, the audit is usually conducted from three months to four years after the transaction has been completed, and settlement is delayed even longer. As an illustration, a case may be cited which recently attracted wide publicity. The Comptroller General in his annual report released in January, 1939, criticized the private use of a Department of Commerce vessel which had allegedly taken place five years earlier in 1933 and 1934. In the meantime, all of the principal officials concerned had left the service. It is obvious that an audit several years old does not aid Congress or the executive officers in maintaining a strict accountability, and the chances of recovery of illegal or improper expenditures decrease with the lapse of time.

Another weakness of the present system is the absence of any effective audit of receipts, which is as necessary and important as the audit of expenditures. The Treasury has consistently resisted the efforts of the Comptroller General to extend his control over the revenues, knowing that once established he would override Treasury decisions on the many questions of taxation. The legal questions involved have never been settled. The present audit is inadequate since it does not go behind the schedule of collections to see that all the taxes paid in actually find their way in the Treasury. As Professor Mansfield puts it, the Comptroller General has an army of inspectors at the front door of the Treasury to check every penny paid out, but only a nightwatchman at the side door where the money comes in.[2] There should be no question whatever of the desirability of a thorough audit or revenues. It would be a protection not only to the public and

[2] Harvey Mansfield, *The Comptroller General*, Yale University Press, 1939.

to Congress, but to the Treasury as well, and if confined to the proper functions of an audit, would probably be welcomed by the Treasury.

Another weakness of the present audit is the fact that Congress has found it necessary to grant to a number of important government agencies partial or complete exemption from the jurisdiction of the Comptroller General. If the functions of the auditing officer were confined to auditing, there would be no justification for such exemptions. It should be noted also that the direct settlements of the Comptroller General, amounting to around $160,000,000 annually are subject to no independent audit. The money is paid out of the Treasury upon the unsupported order of Comptroller General.

Another criticism of the existing audit is that it is concerned wholly with questions of regularity and legality of expenditures. Questions concerning the business practices and accounting methods of the departments are rarely raised, and, indeed, under an audit conducted at a central office, removed from the operations of the departments, it is impossible for the General Accounting Office to raise such questions. Such inferences as may be drawn from the paper evidence without investigation on the spot are apt to be false and misleading. Yet one of the principal values of an independent audit is not merely the verification of the accounts, but the review by the auditor of the business methods and the adequacy and completeness of the accounting system.

Practically the only criterion by which expenditure documents are reviewed by the General Accounting Office at the present time, aside from the accuracy of the computations, is the regularity of the document and the compliance not only with the acts of Congress, but with the rulings and requirements of the General Accounting Office. Since the *raison d'être* of the office, according to its traditions, has been the enforcement of the statutes, it has developed a spirit of legalism and indulged in hair splitting decisions, to the exclusion of more important functions. In the debates in the Senate in 1938 Senator Byrd of Virginia, in defending the existing system, pointed out that a joint Congressional Committee on Public Accounts, such as proposed, would not enforce the law as at present, for it would forgive or overlook "technicalities" where it was apparent that the executive officer had acted in good faith. The point is a good one. The present system is ideally suited to the enforcement of "technicalities." The Comptroller General often refers to himself as the agent of Congress, charged with the enforcement of the letter of the law; and as an "agent," he cannot sanction any departure therefrom, however warranted by public policy or sound business practice, even though the enforcement of the letter of the law—as interpreted by the Comptroller General—may operate to defeat the very purpose of the legislation. Many, if not most, of the "technicalities" enforced by the Comptroller General are not required by acts of Congress, but are based rather upon his particular interpretation of the statutes. Under such a system, compliance with the formalities and regulations becomes an end in itself, of greater importance than the conduct of the work of the government.

Still another criticism of the present auditing system of the government is that it is a mass routine operation carried on almost wholly by persons with only clerical training, and with relatively little use of trained and qualified public accountants. A much smaller force of highly skilled accountants, who have an understanding of accounting principles and methods, and who are qualified to examine and verify the accounts kept by the departments, to go behind the paper documents, to dis-

cover weaknesses, and to report faulty procedures, would undoubtedly provide greater protection than the tedious checking of millions of individual documents by clerical employees. The General Accounting Office staff today consists of around 5,000 persons, many of whom are exempt from civil service and who are employed on the basis of political endorsement. By way of contrast, the force under the Comptroller and Auditor General of Great Britain consists of from 200 to 300 persons.

INCOMPLETENESS OF THE REPORTS OF THE COMPTROLLER GENERAL TO CONGRESS

The primary purpose of the accounting and auditing provisions in the Budget and Accounting Act of 1921, as indicated in the hearings and the debates, was to bring to Congress more adequate information about the financial operations of the government. Members of the committees complained that the six auditors who were attached to the several departments failed to report to them about the financial practices within the departments, and ascribed this failure to the fact that the auditors, though enjoying an independent position in the departments, were members of the executive family. They believed that by making the Comptroller General independent of the executive branch, and by creating a single, unified office to take over the functions of the several auditors, as well as those of the Comptroller of the Treasury, the result would be that Congress would secure the information necessary to hold the executive departments to a strict accounting. In providing for an executive budget, the members of Congress felt that they were making a concession to the Executive, which should be balanced by provision for more effective information to the Congress. The Budget and Accounting Act, accordingly, specifically provided that the Comptroller General should report to Congress not only annually, but from time to time the results of special investigations and in response to its requests, and it was made mandatory for the Comptroller General to report to Congress any expenditure which he discovered contrary to law.

What have been the results? Congress today is as inadequately supplied with information concerning the financial operations of the government as it was in 1921. The Comptroller General has never in the entire history of the office undertaken to supply the Congress with audit reports covering the transactions of any governmental department or agency for any fiscal year, except possibly in a few isolated and unimportant cases. His annual reports contain largely an account of the organization and operations of his own office, with frequent requests for greater power; they are in no sense audit reports on fiscal operations of the departments. They are not useful to Congress in reviewing the financial conditions and practices of the departments and in holding the executive officers responsible. The Comptroller General has not submitted to Congress certificates of the accuracy or inaccuracy of the accounts of the departments, which is customary in public and commercial audits. The very fact that the reports of the Comptroller General to Congress within recent years (except for 1937) have been submitted in typewritten form, and have remained unpublished, indicate the value attached to them both by Congress and by the Comptroller General.

The Comptroller General has supplied individual members and committees of Congress detailed information upon specific items from time to time on request. This, however, is not to be confused with the information which an auditing office should supply to the legislative body, dealing with the accuracy of the departmental accounts, the presence of any unsound

practices or methods, the failure on the part of the executive officers to conform to the statutes governing expenditures, and the most significant and pertinent facts about financial operations, suitably summarized and arranged to be of service to Congress in directing the financial policies of the country. In the last few years, after criticisms were leveled at the office, some irregularities and illegal expenditures have been reported but not in a form suitable for the use of Congress.

There are several explanations why the Comptroller General has failed to supply such information to Congress. The fact that his office does not audit the accounts of the departments, but contents itself with a review of individual transactions, is explanation of why there has been no certificate concerning the departmental accounts. This sytem is also largely responsible for the undue delays in auditing, in some instances with delays involving several years, which make it impossible for the office to submit an audit report on the fiscal operations for any particular year promptly enough to be of any real value. It would doubtless be embarrassing to the office to submit an audit on the financial operations several years after the end of the fiscal year. But perhaps the basic reason why no audit reports have been made to Congress is that the office has been occupied with its comptrolling functions, and has neglected its auditing functions. Under the existing system it exercises very considerable comptrolling powers, and therefore would be placed in an anomalous position if it undertook to criticize operations which it had formerly sanctioned.

ENCROACHMENTS OF THE COMPTROLLER GENERAL UPON ADMINISTRATIVE DISCRETION

Throughout the history of the General Accounting Office there has been conflict in its relations with the executive departments. Disagreements have been continually aired in Congress, and many agencies have been granted partial or complete exemption from the authority of the Comptroller General. The Comptroller General has complained to Congress in his annual reports that the departments attempt to avoid his control, and has repeatedly though unsuccessfully sought additional legislation to bring them to terms. Nevertheless, he has been able to reach out constantly for greater control over administrative matters through his power to disallow expenditures and through advance opinions which have the effect of a set of regulations governing the conduct of administration. Instead of ridding the executive officers of "hampering restrictions" and "red tape," as the Senate committee expected in 1921, the placing of these strong powers of control over administration in the hands of an auditing officer has had just the opposite results. Department officials complain that the decisions of the Comptroller General are sometimes arbitrary and unreasonable, that he has usurped the authority vested by Congress in the executive officers, and that his rulings have often impeded and delayed the work of the departments by requiring unnecessary routine and cumbersome procedures.

It is, of course, natural to expect such complaints of the decisions and requirements of a comptroller. Because of the size of the Federal Government, it is necessary to establish many rules and regulations safeguarding the expenditure of public funds, which would be unwise in a smaller organization. There are limitations and prohibitions in many statutes of Congress, and in the appropriation acts, which must be interpreted and enforced by the official exercising the authority of a comptroller. It should be recognized, however, that rigid, legalistic rulings by a comptrolling officer, if carried too far, not only unwisely

restrict the discretion of executive officers, but impede administration and are destructive of efficiency and economy. This is the criticism which has been made of the operation of the present system. The Comptroller General, being independent of the executive branch (due to the fact that he is also auditor), can and has exercised his authority as a comptroller without regard to administrative results. He is not answerable to any executive officer. As the agent of Congress, which he often professes to be, he believes his duty to be that of interpreting and enforcing the law very strictly. The system requires him to do so, for any leniency would subject him to criticism by Congress, to whom he professes responsibility. Congress, however, has found it necessary to exempt a number of governmental agencies from his authority in order that they might carry on their work effectively. The difficulties of operating under the rulings of the Comptroller General has been, in fact, one of the principal reasons for setting up government corporations which are customarily exempted.

The alternative to the present system of a strict, legalistic, day-by-day control over the routine features of administration, exercised by an officer independent of the executive, is to establish a comptrolling officer within the executive branch, and hence answerable to the Executive for rulings which unnecessarily impede administration, and to supplement this day-by-day control with a prompt, independent audit, which would enable Congress and the President to hold the executive officers to a strict accounting of the funds placed at their disposal. This was the proposal of the President's Committee on Administrative Management.

The most important authority vested in the General Accounting Office is the settlement of accounts and claims. Prior to 1921 this function was performed by six separate auditors attached to the departments, whose decisions were subject to review by the Comptroller of the Treasury. For our purpose here we may disregard the settlements of claims and consider only the settlement of accounts, which involves more than 95% of the fiscal transactions of the government. The accounts which are settled are those of the disbursing officers, who are held responsible for payments which the General Accounting Office disallows in the final settlement of their accounts. The decisions of the office are "final and conclusive upon the executive branch," and are subject to an appeal to the courts only by private parties. While the courts have frequently reversed the decisions of the Comptroller General upon appeal, the number of appeals taken to the courts are negligible, and for decisions of this kind it would not be desirable in any case to provide for frequent appeals to the courts.

The authority of the General Accounting Office to pass upon the legality and regularity of the expenditures of the executive departments is all pervasive. Every individual expenditure comes before it for review, and disallowances, coming months (sometimes years) after payment has been made, are embarrassing alike to the disbursing officers who paid the money out and to the executive officers who were responsible for the expenditure. It should be understood that disallowances do not ordinarily indicate any wrong doing by the executive officers, or any attempt to defraud the government. Such instances are extremely rare. The usual case—aside from petty routine disallowances, such as items in expense accounts—involves a *bona fide* expenditure, made in good faith by the executive officer, in which the government has received full value, and in which there is no question of the wisdom of the expenditure or of the public policy involved. Disallowances are

usually made because the expenditure is not in conformity with the Comptroller General's interpretation of a statute or with his requirements of "necessary documentary proof." They often involve technical differences over legal questions between the attorneys in the departments and those in the General Accounting Office. The opinions of the former are merely opinions, while the rulings of the attorneys of the General Accounting Office are final and conclusive. Prior to 1921, the Comptroller of the Treasury customarily joined with the departments upon objection to his rulings to request the Attorney General for an opinion. This practice, which permitted an appeal by the departments, has been discontinued by the Comptroller General, who has stated that the opinions of the Attorney General are of interest, like those of other attorneys, but of no legal effect. Prior to 1921 the Comptroller of the Treasury also customarily followed court decisions, though stating that he was not bound by the decisions of lower courts. The Comptroller General, however, has consistently refused to change his rulings to conform to decisions of the lower Federal courts.

The means for the collection of disallowances are far from perfect. Except in the relatively small percentage of accounts which are preaudited, the payment has long since been made, the service has been rendered to the government, and except for disallowed payments to government employees, there is no effective means of recovery. The disbursing officer is always a low-salaried official under an official bond which in proportion to his disbursements is negligible in amount. Recovery obviously cannot be made against the disbursing officer, though he is, theoretically, held as the insurer of the legality of the expenditures for which he disburses public funds. Nor can the government recover against his bondsmen, except in cases of personal defalcation or misconduct of the disbursing officer. Disallowances which cannot be recovered stand against the accounts of the disbursing officer until they are cleared by special provisions in subsequent appropriation acts. In the great majority of cases, disallowances are cleared up by extended negotiations with the General Accounting Office, the expenditure finally being allowed upon a more complete explanation, or when the documents are altered to meet the requirements of that office. In some instances the expenditure is allowed, but notice is served that subsequently it will not be.

The collections into the Treasury from disallowances are very small. The exact amount is not indicated by the annual reports of the Comptroller General, for this item is mingled with other collections made by the office, but it appears that the total actually collected as a result of disallowances amounts only to two or three million dollars annually, or even less. In proportion to the total expenditures of the government, this amount is, of course, negligible, but the value of the audit is not to be measured by the amounts recovered.

While it might appear from the above that the sanctions of the General Accounting Office are far from complete, and in most instances disallowances are forgiven by Congress, actually the authority of the office over the departments is very great. Executive officers face the certainty that all expenditures will come before the General Accounting Office for review, and disallowances are not only embarrassing, but reflect upon the department. The executive offices must operate within the limits of the decisions of the Comptroller General, wise or unwise, and regardless of their effect upon administration. Consequently, when a new activity is about to be initiated, a new procedure or organization utilized, or anything out of the ordinary

routine arises, expediency as well as timidity lead the administrators to seek advance approval by the Comptroller General of their plans. This is done by requesting an advance opinion, which the Comptroller General is authorized to render by the Dockery Act of 1894.

The practice of the old Comptroller of the Treasury to issue advance opinions dates back beyond 1894, though not sanctioned by law until that time. Prior to 1921 the Comptroller interpreted his authority strictly and declined to pass upon administrative matters unless it was necessary to do so. Relatively few requests came to him for such opinions. Commissioner Warwick testified in the hearings on the Budget and Accounting Act in 1920 that the number ran only about fifty to sixty annually, though he thought it ought to be several hundred. Prior to 1921 the departments were not forced to go to the Comptroller constantly for advance opinions, and on many legal questions consulted the Attorney General instead. Usually they could secure an agreement with the auditor assigned to the department, who was ordinarily willing to accept any reasonable interpretation of the department's attorneys or of the Attorney General. If the auditor sanctioned a proposed expenditure, the departments could safely go ahead, for it would not be disallowed by the Comptroller. In theory the Comptroller reviewed the audit of the six auditors, but in practice his review was confined largely to questions referred to him by the auditors, or to appeals from their action by the departments. While the departments frequently consulted the auditors, the interpretation of the statutes under which they operated was left almost wholly to the departments and to the Attorney General.

Since 1921 the use of advance opinions by the Comptroller General has been greatly expanded. The number of such opinions now runs about 10,000 annually,[3] of which only a few of the most important are printed. More and more the device is used to secure a review and advance approval by the Comptroller General of the administrative plans of the departments. It might be supposed that such plans would be subject to review by the responsible officers, but in fact the approval of the Comptroller General is frequently more important. Likewise, it might be supposed that the departments would turn to the Attorney General for legal advice upon the scope of their authority, and for interpretations fo the statutes relating to departmental operations, but in fact this function has been taken over largely by the Comptroller General. The Attorney General gives advice on the voluntary request of the departments, but his opinions will not aid them if expenditures are disallowed. The opinions of the Comptroller General are secured because behind them stands the sanction of disallowances.

In theory the function of the Comptroller General is merely that of interpreting and enforcing the statutes and the terms of the appropriation measures, but in fact his interpretations often go far beyond any contemplation of Congress, and at times operate to defeat or to make difficult the execution of policies adopted by Congress. Many of his opinions relate only very incidentally to any act of Congress, and occasionally his rulings are based solely upon his ideas as to what constitutes sound practice. The Comptroller General has often stated that if the departments are dissatisfied with his decisions they may appeal to Congress, and some of his decisions have been overruled by specific provisions attached to subsequent appropriation acts, but this procedure is utilized only in extreme cases, for departments are usually unwilling to raise such questions

[3] See statistics in annual reports of the Comptroller General.

at the time they are seeking new appropriations. Government officials are prone to accept without protest limitations which are imposed upon them, excusing inefficient and uneconomical practices as a necessary incident of public administration. Bureaucratic officials even welcome and embrace a system of detailed external control, for it frees them from being held responsible for administrative results.

The advance opinions and disallowances of the Comptroller General constitute a mass of rulings governing the conduct of the work of the departments, which executive officers must know at their peril. Administrative decisions must be made within this framework. These rulings deal not only with whether a given activity is authorized by law and comes within the terms of the appropriations, and does not violate other statutory provisions, but more often they deal largely with administrative methods. The Comptroller General has often urged the departments to come to him with their problems, and offered to aid them to find a way to carry out their programs within the terms of the statutes and his decisions. The effect of his opinions disapproving departmental plans, accordingly, is not to prevent unauthorized or illegal activities, and to turn the money back to the Treasury, as frequently believed, but rather to require the departments to seek alternative methods or procedures—presumably less suitable and hence more expensive—to accomplish the same results. One thing is certain: the rulings of the Comptroller General do not "save" money by preventing the departments from spending their appropriations. They do not reduce governmental expenditures, for the departments always find other, perhaps less economical, methods of spending the funds appropriated. Some of the severest critics of the present administration defend the Comptroller General as a "check" upon the spenders, without stopping to observe that he has not curtailed the expenditures which they criticize. While many of his rulings are sound, and others are necessary under the terms of the statutes, nevertheless, many impede administrative operations and are justifiable only by a particular and legalistic interpretation of the statutes.

Since the authority to issue regulations governing expenditures is lodged with the independent auditor, it is to be expected that his decisions on all sorts of questions of organization, personnel, finance, methods and procedures will be those of an auditor rather than an administrator. They frequently overlook departmental requirements and operations, for the auditor does not have expertness and an intimate understanding of administrative problems which only comes to those who are actually engaged in administration. The qualities which make him expert as an auditor are not those required of administrators.

Another basic defect of the fiscal system of the Federal Government is that the Comptroller General exercises administrative power, but cannot be held responsible for the results of his administrative decisions.[4] An auditor has no responsibility for administrative results. Executive officers, on the other hand, who are responsible for administrative results, make decisions which are overridden by the Comptroller General, and consequently escape responsibility. The system operates to weaken the most important element of administration—the definite fixing of responsibility. It gives an alibi to the

[4] The point was well stated by Mr. George P. Auld, Auld, chairman of a special committee on Government Reorganization of the American Institute of Accountants, in a letter to the *New York Times*, February 2, 1938, as follows:

"It seems as unnecessary as it is illogical to permit an official, whose special qualifications should be those of a professional auditor, to intervene in operating matters and wield extraneous powers duplicating and overriding the functions of those who have to answer for operating results."

bureaucrat for failure to carry out the duties of his office efficiently and economically.

The interference of the Comptroller General in administrative functions can be illustrated by a few specific cases reported by the executive departments to the Senate and House Committees on Government Organization. Under the provision of the Merchant Marine Act of 1936 which requires "any officer or employee of the United States traveling on official business to use ships registered in the United States if such ships are available, unless the necessity of his mission requires the use of a ship under a foreign flag," the Comptroller General ruled that foreign officers of the State Department must secure his approval before sailing on a ship under a foreign flag. The Secretary of State reported that this "necessitated delays and a great deal of expense to the government for telegraphing, since travelers must submit facts and comparative costs of travel . . . and await decisions of the Comptroller General." Secretary Hull cited the following case, among other decisions of the Comptroller General which "ignore the consideration of great importance to the department: An officer was transferred from Lisbon, Portugal, to Rio de Janeiro, Brazil, between which posts there is direct sailing of foreign vessels. He was required to proceed to New York and then to Brazil at considerably added expense."

The Comptroller General caused a delay of a year and a half in securing wire and cable for the Boulder Dam plant. On May 27, 1935, bids were opened, and the Secretary of the Interior awarded the contract. A protest by a competing bidder was filed with the Comptroller General, who called upon the Interior Department for the bids and a complete report. It was not until a year and a half later, despite repeated efforts of the Interior Department to secure a decision, that the bids were returned and the original action of the department approved so that the contract could be executed. This is one of numerous reported cases of excessive delays caused by the Comptroller General. Sometimes these delays are defended on the ground that a little delay may be a good thing, but the effect of delays and uncertainty may be devastating upon administrative operations. Public administration at best is carried on under considerable handicaps; if administrative officers are forced to operate constantly under a cloud of uncertainty as to the legality of their acts—regardless of how judicious or necessary they may be to accomplish the tasks assigned them—the effect is to rob administration of its vitality.

An extremely wide variety of decisions affecting all aspects of administration have been made by the Comptroller General, unquestionably at times without adequate attention to and understanding of administrative problems. Many agencies report that the Comptroller General has required the purchase of equipment or technical instruments poorly adapted to their needs, which proved to be very expensive in the long run. Several years ago the Comptroller General required the Navy Department to discontinue the practice of more than fifty years of permitting ship building companies to submit alternative designs, thus utilizing the highly specialized designing engineers in the employ of private firms submitting bids. Although the department protested vigorously, and cited an early statute specifically authorizing the practice, the Comptroller General refused to modify his ruling. Recently the Comptroller General ruled that the department may not pay private agencies for credit reports on prospective employees, which departments have utilized at nominal expense to supplement their own investigations. The Comptroller General was

apparently unconcerned as to whether this information is needed and the additional expense to which the department might be put by his ruling to secure it.

These cases are typical of the great mass of such instances submitted by the departments to the joint committee of Congress on Reorganization in 1937, and of many more concerning which administrative officers at Washington constantly complain. Taken individually, these rulings may appear unimportant. Few, indeed, cannot be justified upon some ground, particularly if it is assumed that administrative officers cannot be trusted without setting someone constantly on guard to check the legality of their every act. Collectively, these rulings seriously impair the work of the government, and involve it in an endless amount of cumbersome procedure, "red tape," and unnecessary and expensive formalities. No private business firm or corporation would think of attempting to carry on its work under similar restrictions.

It is a cardinal principle of administration in government as well as in business undertakings that persons who are placed in charge and who are held responsible for results must be given authority commensurate with that responsibility, and must be permitted a reasonable discretion in directing those under them. If the auditor is permitted to direct or to control the day-by-day operations, the result inevitably is to destroy any real responsibility, and to impair administrative management. That this has been the actual result in the Federal government has been attested to by many executive officials. It was for this reason that the President's Committee on Administrative Management believed that some modification of the present financial organization is essential to the development of improved management. The committee did not recommend that the departments be given an unlimited discretion in the conduct of their operations. The need for a comptrolling official who would exercise day-by-day control over the fiscal operations of the departments, including decisions of doubtful legal quesions, was recognized, but it was recommended that this official should be within the executive branch, and that his decisions should be subject to a review by the Attorney General if the departments regarded them as arbitrary or injurious to efficient operations. All decisions of the comptrolling officer, as well as the financial transactions of the departments, would be subject, under the plan recommended, to an independent audit by an Auditor General responsible directly to Congress, whose prime function would be to report not only on his audit of the accounts of the departments, but upon any expenditures or rulings which he thought to be unauthorized or contrary to any statute. The final decision in such cases would rest with Congress, but the action of the department, and the interpretation of the law by the Comptroller and the Attorney General would stand until overruled.

FAILURE TO DISTINGUISH BETWEEN ACCOUNTING AND AUDITING

The basic fault of the present fiscal system of the Federal government is the failure to distinguish clearly between the separate and distinct functions of accounting and auditing, and the merger of these two functions in the hands of a single official. In 1934 a committee of the United States Chamber of Commerce stated that the "Comptroller General is now in the anomalous position of auditing his own accounting." The committee of the Chamber recommended that "accounting should be segregated from auditing, and that accounting should be centralized in an agency under the control of the President." The Comptroller General is now *both* a comptroller *and* an auditor. As comptroller

he is the chief accounting officer of the Government, maintains certain central accounts, prescribes the accounting systems in use in the departments, settles claims, issues advance opinions which have the effect of a set of fiscal regulations, and passes on how and for what purposes appropriations may be spent. In view of these duties, it is obvious that he cannot effectually perform his duties as an auditor for he is called upon to pass upon his own previous decisions, criticize accounting systems which he had prescribed, review the legality of acts which he had previously allowed, and, to some extent, audit his own books. Any criticism which he might make in his capacity as an auditor would be a reflection upon his work as a comptroller.

The distinction between auditing and accounting is one that is universally recognized in business practice. Accounting, including accounting control, is regarded as a function of management. The independent audit, on the other hand, is a means whereby the board of directors can hold the management responsible for the execution of the policies it has determined. To be of any value, the audit must be made by persons who have had nothing whatever to do with keeping the accounts or with the execution of decisions. For this reason it is recognized in business practice that the audit must be independent. The usual practice is to employ an outside auditing firm at the end of the year to go over the books of the company and to make an audit report to the board of directors. The accounting and the day-by-day control of expenditures, on the other hand, are left to the management.

The principle of a clear-cut separation of accounting and accounting control from auditing is as applicable to government as it is to business. It was recognized in England 70 years ago, and is a fundamental feature of the British fiscal system. Edward Romilly, Chairman of the Board of Audits, wrote to the Select Committee of Parliament in 1857:

> The duty of an auditor of public accounts should be to pass in review the acts of an accountant, after those acts have been completed. . . . The more strictly this duty of the auditor is confined within these limits . . . the greater will be the security of the public.

The confusion of auditing and accounting in the Federal Government has been strongly condemned by writers on public finance.[5] Practically all studies of State financial administration and surveys of State government have recommended the separation of auditing and accounting, the creation of a comptrolling official directly responsible to the Governor, and an independent auditor responsible to the legislature. Many states and cities have adopted laws within recent years clearly separating accounting and auditing, but it is still common for the two functions to be confused.

THE NEED FOR A CONGRESSIONAL JOINT COMMITTEE ON PUBLIC ACCOUNTS

An important recommendation of the President's Committee on Administrative Management, which is frequently over-

[5] Professor H. C. Lutz, in his work entitled *Public Finance*, criticizes the system for "the failure to distinguish between the comptroller and auditor function." A. E. Buck, in his work *The Budget in Governments of Today*, points to the "dual position" of the Comptroller General, and states that his duties are "inconsistent and illogical," since he virtually becomes the "auditor of his own accounts." W. F. Willoughby, formerly head of the institute for Government Research of the Brookings Institution, and often referred to as the "father" of the Budget and Accounting Act of 1921, in the 1936 edition of his *Government of Modern States*, criticizes the system, stating that it is a "basic error" not to distinguish and separate the functions of the comptroller and the auditor. He goes on to say:

"The most striking example of where this faulty procedure has been followed is presented by the national government, which, in creating its General Accounting Office, presided over by the Comptroller-General, has vested the performance of these functions in the hands of the same officer—a procedure which has given rise to much trouble in operating a system which otherwise has great merits."

looked, was that Congress should create a joint committee on public accounts, whose function it would be to receive the audit reports of the Auditor General, to conduct hearings at which it would call before it the executive officers whose acts had been questioned, and to make suitable recommendations to Congress from time to time. It was anticipated that this committee, which was provided for in the Reorganization Bill of 1938, would hold sessions not merely on the occasion of the annual audit reports, but more frequently throughout the year whenever the Auditor General had matters to lay before it. The proposed plan called for a prompt audit of governmental expenditures, conducted in the field, and provided that the Auditor General should report to the comptroller in the Treasury any item which he questioned, and unless the matter were settled to his satisfaction, he should then report to the committee on public accounts of Congress. In this way any departmental expenditure which the Auditor General thought to be unauthorized or in violation of law, or contrary to sound business practice, would be brought promptly to the attention of Congress.

The absence of any committee of this kind is an important weakness in the existing legislative organization. It is not to be expected that the audit reports will be effective if merely fired broadside at Congress, without any machinery set up to receive and act upon them. An independent audit is of little value to the legislative body unless it has this necessary machinery.

The utility of a joint congressional committee on public accounts is probably best illustrated by the history of the Committee on Public Accounts of the English House of Commons, which receives and investigates the audit reports of the Comptroller and Auditor General, an officer whose functions, despite his title, are limited to auditing. This committee is one of the most important of the House; by custom its chairman is a member of the opposition party. It does not concern itself with trivia, or technical legal questions; nor does the Comptroller and Auditor General. (In England the Treasury is authorized to make expenditures not specifically appropriated for by Parliament, but related to authorized purposes.) The Comptroller and Auditor General certifies the accuracy of the accounts submitted by the departments, which is uniformly a brief, stereotyped certificate; in addition, he reports upon any financial practices including accounting, to which he takes exception, and the executive officials are called before the committee to explain. For example, in a recent year, he reported, among other things, that the public employment exchanges were using high priced land in some large cities for local exchanges. Another report dealt with the letting of contracts for military airplanes. Since the great majority of such contracts were being let to a single bidder, without actual competition, the Comptroller and Auditor General investigated to ascertain whether the authorities were properly protecting the public interest, and reported that while he was convinced that the necessary steps in cost accounting were being taken, nevertheless, he recommended that greater effort be made in the future to secure competition. At the end of its hearings, the Committee on Public Accounts instructs the Treasury to make certain changes in the future, or to report back to it at subsequent meetings why it is not advisable to do so. Its wishes are carried out without the necessity for formal legislation.

It seems probable that a joint Committee on Public Accounts in this country would serve an equally important role, particularly since, under the proposed plan, the Auditor General would provide

the staff for the committee, and the prestige of his office would turn largely upon his ability to make the committee effective. It is difficult to see how else executive officers can be held to an accounting to Congress for the moneys voted to them. The fact that their accounts are to be audited, and that they may be called before this committee to explain and defend any expenditures to which the Auditor General has taken exception, will constitute a powerful sanction against improper or illegal expenditures. The fear of investigation, particularly where investigation is certain and machinery exists to follow it up, is a powerful deterrent to wrongdoing.

LEGISLATIVE AND EXECUTIVE CONTROL OVER EXPENDITURES

The controversy over the proposed changes in the fiscal organization of the Federal government has heretofore turned largely over the issue of Congressional versus Executive control over expenditures, many persons opposing the proposed reorganization because they believed it would decrease the authority of Congress and enhance that of the President. It has been commonly assumed without inquiry that the proposed plan would lessen the voice of Congress in the financial policies and practices of the government—an assumption which warrants investigation. Much of the argument has involved the *rights* of Congress and the President, rather than what are the essentials of sound organization and practice.

It should not be easily assumed that the interests of the President and of Congress are necessarily opposed. Both are equally concerned with securing efficient administration and judicious spending of public funds, under a syrtem which will permt executive officers to be held to a strict accounting. The true criterion by which any fiscal organization or proposed reform is to be judged is not whether it provides the Congress or the President with greater control, but rather whether it is in accordance with sound principles. It is important for Congress and the President each to have adequate means to carry out their constitutional functions in relation to public expenditures, but it is not to be assumed that a detailed control by either would be desirable. Neither is equipped to make decisions on routine operating matters, and when they attempt to do so administration suffers. The President and Congress alike should be concerned with broad financial policies rather than detailed procedures.

In defense of the existing system it is argued that administration must be controlled in the expenditure of public funds, and since Congress cannot exercise the control itself, and does not trust the executive officers and the Executive to do it, an independent auditor acting as the agent of Congress must be given the authority to enforce appropriations acts and other laws relating to finance.[6] This argument is based upon the assumption that if the Legislature does not trust the Executive to enforce the laws, it should set up its own agent to do so—an assumption which does violence to our constitutional system of three coördinate branches of government. As Woodrow Wilson has well said:[7]

"If there be one principle clearer than another, it is this: that in any business, whether of government or of mere merchandising, *somebody must be trusted*, in order that when things go wrong it may be quite plain who should be punished.... Human nature is much the same in government as in the dry-goods trade. *Power and strict accountability for its use* are the essential constituents of good government. A sense of highest responsibility, a dignifying and elevating sense of being

[6] For a statement and brilliant analysis of this argument, see Harvey C. Mansfield, *The Comptroller General*, Chap. I, Yale University Press, 1939.

[7] Woodrow Wilson, *Congressional Government: A Study in American Politics*, pp. 283–284.

trusted, together with a consciousness of being in an official station so conspicuous that no faithful discharge of duty can go unacknowledged and unrewarded, and no breach of trust undiscovered and unpunished,—these are the influences, the only influences, which foster practical, energetic, and trustworthy statesmanship. . . . " (Italics as in original.)

The issue is not whether Congress or the Executive should "control" the executive officers. Each should exercise appropriate controls in accordance with the fundamental division of powers between the executive and legislative branches. The control to be exercised by Congress is legislative in character; it must be exercised by passing laws, and by holding the executive officers responsible for the faithful discharge of their duties. This authority by its very nature cannot be delegated. The argument that Congress cannot itself exercise legislative control over the executive departments is unwarranted; Congress can exercise that control if it has the necessary information, if it knows how the executive departments and the comptroller have carried out their instructions. It needs the help of an independent auditor to secure this information, but having obtained it, Congress is well able to hold the executive departments responsible for their actions.

There is no greater protection against maladministration and the abuse of discretion than the fear of investigation by Congress. Under the proposed plan Congress would be provided with a constant stream of information concerning the conduct of the work of the government, and would be equipped to investigate any abuses reported to it. The resulting control which Congress would exercise over the executive departments would be greatly increased, for at present it learns of administrative abuses only in a haphazard and occasional manner, and has no means for continuous investigation of administration. It is often erroneously assumed that the Comptroller General speaks for Congress and exercises Congressional control, but the Comptroller General is not Congress.

Congress is much better able to hold the administrative officers to an accounting than an independent auditing officer who claims to be an "agent" of Congress—an "agent" who has found it unnecessary to report to his principal. The Comptroller General, acting as an agent of Congress, must hold the executive officers to the strict letter of the law, as he sees it, and permit no deviation however slight and however necessary to carry out the purposes and policies of Congress in enacting the legislation. Acting as an agent, he feels under compulsion to adopt a strict, legalistic point of view. He is not authorized to consider the merits of the administrative actions, and if he did so he would substitute his judgment for that of the responsible executive officers. The present system is especially designed to enforce the technicalities and to disregard matters of importance.

A committee of Congress, on the other hand, will be in an entirely different position. It can and will readily forgive failure to conform to the letter of the law, or to a technical interpretation of the law, where it appears that the action of the administrative officer was reasonable and wise. It will look to the substance rather than to the form, and will call the executive officers to an accounting for any actions of importance which are unauthorized or unbusinesslike.

It is sometimes contended that the system which gives Congress the greatest degree of control over the expenditures is best, and that Congressional control is the prime consideration in considering fiscal organization. Under the Constitution Congress has a dominant position with respect to finance. It levies all taxes and votes all appropriations. The Presi-

dent may propose tax measures, and submits an Executive budget, but final decision rests with the Congress, with the President exercising a veto power. Congress also may attack any conditions which it deems proper to the appropriations, and may by law govern the use of public funds as minutely as it sees fit, but the power to do so does not necessarily mean that it is wise for Congress to enact detailed regulations, unless there are special reasons therefor. Congress has usually wisely refrained from cluttering up administrative processes with detailed statutory limitations and restrictions, but over the years there has been an accumulation of such provisions, each designed to correct a particular abuse, which often have outlived their usefulness, and remain to impede administration. The Senate Committee in 1921 wisely deplored these "hampering restrictions." It would be desirable for Congress now to codify the existing statutes governing expenditures, making them more uniform and effective, and repealing those which no longer fit the present situation and problems.

CONCLUSIONS

There is serious need for the improvement of the accounting, reporting, and auditing of the Federal government. The evidence indicates that in many respects the accounting methods and practices are not up-to-date, and do not provide the essential financial data to the departmental executive officers, the President the Bureau of the Budget, the Congress and to the public. The accounting system is not integrated and hence does not permit adequate financial reporting to provide an accurate and detailed picture of the financial condition of the government, including its principal funds and major operations. No well-managed private business attempts to operate without such information constantly at hand. Many city and state governments, whose budgets are small in comparison with that of the Federal government, have much more adequate, prompt, and complete financial reporting. That it is practicable to set up an accounting system which will provide such information essential to management is indicated by the accounting system which has been in operation for several years for emergency work-relief expenditures.

The improvement of the accounting systems of the departments and bureaus will require constant and continued expert attention and study. The road to such improvement would appear to lie in building in each major governmental unit a competent accounting office, headed by a trained and experienced accountant, who is made responsible for departmental accounting. Since uniformity is desirable in certain accounting records, as well as classification and terminology, and is essential to consolidated financial reporting, the departmental offices should be subject to general requirements of a central accounting office on such matters. It should be the function of the central accounting office of the government to maintain central accounts, to provide consolidated financial reports, and other information from time to time on request of executive officers or Congress, to provide advisory technical assistance on accounting methods to the departments, to investigate the adequacy and completeness of departmental accounting from time to time with authority to report thereon to the President, and to provide leadership in the development of strong departmental accounting offices. In order that accounting may be directed at the needs of executive management rather than merely providing adequate records for auditing purposes, the central accounting office of the government should be located within the executive branch and subject to executive control.

The auditing system of the Federal government at present is even more seriously defective. The major defects are due in large measure to the failure to distinguish between accounting and auditing, and to provide an auditing officer whose sole function is to audit the accounts of the government and to report thereon to the President and to Congress. In the ordinary sense of the word, there is no independent audit conducted at present. Since the Comptroller General exercises comptrolling functions, he is not truly independent as an auditor; and he does not audit the accounts of the departments. Congress is not provided with the audit reports which it needs to hold the executive officers to an accounting. An effective, prompt audit would also be of great value to the President and to the executive officers, who are responsible for the actions of their subordinates.

The present audit is seriously defective because of its routine character, the fact that it is conducted at a central office rather than in the departments and the field where the accounts are kept, and because it is considerably delayed. The most serious criticism of the present audit, however, is the encroachment of the auditing officer into matters of administrative discretion, and the issuance of thousands of opinions and rulings which unduly hamper administration. It is contrary to sound principles to place such authority in an officer charged with auditing. It robs executive officers of authority which they must exercise if they are to be held responsible for the efficient and economical conduct of the work entrusted to them; it places that authority upon an officer who cannot be held responsible for results. An auditor, either in business or in government, should not keep accounts, but should audit the accounts kept by others; he should not make or participate in administrative decisions, but should be free to review and to criticize the decisions made by those in charge.

The work of auditing is important and exacting; it provides the principal means whereby the legislative body may hold executive officers accountable; and it requires the undivided attention of a competent staff. The improvements which are needed in the auditing of the Federal government require the establishment of an office charged with this sole responsibility, and equipped with a competent staff of trained accountants who are qualified to examine and verify the accounts of the departments and to review and criticize their accounting practices.

Some of the improvements here suggested could be accomplished without legislation, provided there is whole-hearted cooperation between the departments and agencies concerned. It seems unlikely, however, that the most important improvements can be made until there is a clear-cut distinction between accounting and auditing, and definite responsibility is established for the conduct of each of these important functions in accordance with sound principles and accepted practices. From every consideration, the Federal government should have the most up-to-date, adequate, and complete system of accounting, reporting and auditing. To bring the financial administration of the Federal government up to date, there is needed: first, a sound financial organization under which clear-cut authority and responsibility is established for financial administration; second, the development of competent, highly trained accounting staffs throughout the government; and, third, the constant study, investigation, and improvement of the accounting, reporting, and auditing.

FEDERAL ADMINISTRATIVE TRENDS AND ACCOUNTABILITY

HERBERT EMMERICH

THE outstanding Federal administrative trend is, of course, the enormous increment of new responsibilities which has accrued to national administrative agencies. The familiar fact that the budget of Federal expenditures is twice as large as ten years ago and over six times as large as twenty-five years ago is but an indication of this growth. The mere recital of a quantitative measure, however, does not by any means tell the entire story. For in many cases the new functions are of a regulatory nature and do not in themselves involve great expenditures, and even in many of those of a service nature, their complexity is not apparent in the size of their budgets. Today you find the impact of the newer administrative Federalism all about you. You may drive your car over a Federally-aided road to an airport where you take a plane subsidized by the Civil Aeronautics Authority. You arrive at another city after passing over a Federal system of air beacons and land safely because of Federal weather reports. You may finish your journey in a railroad financially assisted by the Reconstruction Finance Corporation and regulated by the Interstate Commerce Commission. In fact, you may stay overnight at a hotel acquired by the Reconstruction Finance Corporation Mortgage Company as a result of a foreclosure of collateral taken out of a frozen bank. You go to your national bank belonging to the Federal Reserve System and make a deposit insured by the Federal Deposit Insurance Corporation. You buy some securities after looking over the prospectus prepared according to the requirements of the Securities and Exchange Commission. You return by sea on a steamer subsidized by the Maritime Commission, and on your journey you listen to broadcasts by stations regulated by the Communications Commission. At home you pay the interest on your Federal Housing Administration or Home Owners' Loan Corporation mortgage. There is a strike in your town being handled by the National Labor Relations Board or being mediated by representatives of the Department of Labor. You spend some time filling out forms for your employees for Social Security taxes and you fill a vacancy in your shop by calling up a Federally-assisted employment exchange. The new employee must work at Federal rates for wages and hours. One of your friends is down on his luck and is forced to take a job on a white collar survey project under WPA. Your farmer brother is financed by the Farm Credit Administration and enjoys soil conservation and agricultural adjustment benefits as well as the advice of Federally-assisted county agents. His electricity comes to him by means of a Rural Electrification Administration line. And dozens of other examples could be cited of the impact of new Federal services, not to speak of many older ones, on our daily lives.

This tendency to place additional duties and responsibilities on the Federal Government is, of course, not new. It has been the secular trend right from the beginning of our history, accentuated in velocity in this century and taking a very sharp upswing beginning in 1931. The production of new Federal programs in the last twenty-five years has been unprecedented in volume, complexity, and national effect, not only in comparison with that of any prior quarter century, but in comparison

with that of all the previous 125 years of our Constitution put together. Two devices are worthy of particular mention in connection with this growth as their use seems to be in the ascendancy: one is the increasing employment of the conditional grant-in-aid from Federal to state and local governments; the other is the tendency to employ the Federal corporation as an administrative device. It is a marvel that our public administrative capacity suddenly taxed in this way has done as well as it has. Vast new problems of public policy and administrative management have been created by this growth; and above all, there has been the increasing difficulty of meeting the problem of accountability.

Let me describe here briefly what I mean when I use the term "accountability." I am referring, of course, to the vital element which differentiates the form of government we live under from despotic forms abroad. I refer to the underlying assumption of a free representative democracy: that its appointive officials are responsible to the general executive who, in the case of our national government, is elected by the people; that this executive is in turn responsible to the general legislature which represents the general body politic. This element of accountability can conveniently be subdivided into three important aspects.

There is first of all the accountability to the particular group served by a governmental agency. The term "client" has become familiar in regard to beneficiaries of relief and welfare programs, but the growing Federal establishment is performing regulatory work as well as service work, and the word "client" scarcely suits the regulated. Let us call them "regulatees." The first accountability, we will say, in a country whose laws are based on a bill of rights, is accountability to the client or to the regulatee, as the case may be. Now the protection of the rights of the individual in relation to the administrative agency is a very important question. I do not wish to appear to minimize its importance if time requires me to treat it hurriedly or when I say that it is occupying a disproportionate amount of space in the law reviews and in the newspaper columns these days. This extension of the area of discretion to administrators under laws setting down very general standards and powers is, of course, a major administrative trend in Federal government, and for that matter in state and local government. It is unquestionably a function of our highly technical and specialized age and even more of the increasing velocity in the rate of social change. Legislatures find it not only impossible to prescribe in detail for every contingency in the many, many technical fields they find it necessary to deal with, but indeed realize the inexpediency of too greatly restricting the administrative agency in a society in which the only certainty seems to consist of the fact that the situation will continue to be different at an accelerating rate. To a certain extent, the individual, the client or regulatee, has always the protection of an appeal to the judicial branch. However, we know very well that this is by no means a complete protection, for in many instances the expense and delay of litigation make it an inefficient remedy for administrative error. A good deal of progress is being made in the rule-making process itself. Administrators are increasingly employing the device of consultation with national advisory boards before administrative policies, regulations, and procedures are promulgated. The inauguration of the publication known as the "Federal Register" is a step forward in formal publication and dissemination of departmental rules and regulations. The device of formal and informal hearings before rules are made and after they have been applied to individual cases is being improved, and various types of

appeal bodies are being used. This trend toward an increased recognition of the importance of accountability to the citizen who is served by a Federal agency is further illustrated by the improvement in the form and content of government documents describing the rights and privileges of clients and regulatees under newly enacted legislation.

The old questions as to the dividing line between policy determination and execution become increasingly complex as the areas of administrative discretion are widened. The problem of permanent able and honest personnel becomes increasingly important with the widening area of administrative decision, for we need men who have grown up in a discipline of restraint and breadth and knowledge to exercise these fast-increasing powers. There is a wide range of problems unsolved here for research and thought and for practical experimentation. It is a major challenge to the whole field of public administration.

Let me deal now with the second phase of accountability, and that is the accountability to the special purposes of new legislation. Most of you are familiar no doubt with the interesting clause in the Act creating the Tennessee Valley Authority which requires its officers to make a statement upon appointment that they believe in the purposes and feasibility of the Act. It sounds new, but it really isn't so different in spirit from the oath required of the President under the Constitution which was drafted when the whole idea of a republic was as new as the TVA is today. I believe that loyalty to a program is a very important part of the accountability of a Federal administrative agency. And in a new activity it must be specially vigorous and aggressive while it is establishing its traditions and reputation. To play with the word, a new agency must give the best possible "account of itself" in its new field so that whether the program is continued, amended, or rejected, will not be due to administrative lethargy or ineptitude. I shall not dwell on this subject too long, but a whole treatise is needed on what might be called the obstetrics and pediatrics of public administration—the birth and postnatal care of new government agencies. Before leaving this type of accountability, however, I will mention the fact that a new agency always has a certain chance of success. The reason for this is simple: the new agency has so many fathers. I refer, of course, to the members of the pressure groups who helped to have it created and who solicitously follow its progress.

Now the story of how new Federal programs come into being leads me into my major theme, and that is the third principal element of accountability—the accountability in a free representative democracy of administrative agencies to the general executive and his accountability in turn to the general body politic through their legislative representatives. This major accountability must always be reconciled with the other types of accountability, but without it the democratic system is violated. And, strangely enough, all of us in our preoccupation with special programs are less interested in the whole than in some of its parts. Most of the time we are watching the sideshows of democracy and forgetting the main tent. Let us see why this happens.

Perhaps I should dwell for a moment on what the anthropologists call, I believe, "ecology"—the ecology of a new Federal agency, and then I think some of the administrative problems will emerge plainly enough. Here is a rough description of how a new one is born. A group of citizens, be they investors or farmers or wage-earners or aged persons or unemployed or home owners or manufacturers or fishermen or even accountants, are aroused by some dislocation which they are persuaded affects their interests or jeopardizes their

security. They form associations, delegations, committees; they petition legislators and departments; they indulge in press releases. A report is made. A bill is drafted and introduced. Each sponsoring group follows the progress of its own program, often unaware of many similar ones. Every effort is made to keep the new activity separate from the rest of the general government in which it is expected to find its place. Every pressure group is sure of the purity of its own motives and of its ability to guide and control the newly born agency if only the favorite child is kept away from the contamination of other activities in the general government. As the saying goes, it is to be kept "out of politics," which usually means it should be responsive only to the crusaders who brought it forth and is not to be trusted to the general government which is supposed to reflect the general will and the total welfare of all the citizens. The result is administrative problem No. 1, the particularism or centrifugal tendency of new agencies; their resistance to administrative coordination with the entire program, indeed often with closely related programs; their tendency to self-sufficiency and parochialism; their preference for reporting to pressure groups instead of to the whole country; their preference for being removed from executive authority; and their preference for being accountable to specially interested congressmen and senators rather than to the Congress of the United States as a whole.

Now I am not undertaking here a general indictment of pressure groups, for they are powerful and valuable energizing factors in the body politic. I am merely reviewing the not unfamiliar fact that they invariably tend to create a vested interest in various departments of government and that long after they have brought a new governmental agency into the world they continue to expect it to be accountable only to them and not to the general body politic, the general legislature, or the general executive. This centrifugal tendency is a long-time trend in our government. It has been attributable in part to other causes than these pressure groups, such as our preoccupation with checks and balances, our sad experiences with patronage and pork, and our unfortunate tendency to distrust our own political institutions.

If we take a look at the executive branch of the Federal Government, we see this centrifugal force having two principal effects. First, the proliferation of independent agencies outside of the regular departmental structure; and second, the weakness of over-all tools of management and coordination provided for the President.

The first tendency is at least fifty years old and started with the establishment of the Interstate Commerce Commission. Before that all activities were in regular departments. In his message to Congress of April 25, 1939, submitting his First Plan of Government Reorganization, President Roosevelt said:

> Forty years ago in 1899 President McKinley could deal with the whole machinery of the executive branch through his eight cabinet secretaries and the heads of two commissions; and there was but one commission of the so-called "quasi-judicial" type in existence. He could keep in touch with all the work through eight or ten persons. Now, forty years later, not only do some thirty major agencies (to say nothing of the minor ones) report directly to the President, but there are several quasi-judicial bodies which have enough administrative work to require them also to see him on important executive matters. It has become physically impossible for one man to see so many persons, to receive reports directly from them, and to attempt to advise them on their own problems which they submit. In addition, the President today has the task of trying to keep their programs in step with each other or in line with the national policy laid down by the Congress. And he must seek to prevent unnecessary duplication of effort.

To illustrate further this situation, I remember a meeting at the White House in

1935 of the National Emergency Council, a body including members of the cabinet and heads of the various independent agencies, old and new, intended to act as a policy group. Over fifty people crowded into the President's office. There were not enough chairs. No discussion of important policies was feasible in such an improvised mass meeting. A sterile agenda resulted and the meeting could find nothing more vital to discuss than some minor questions of telephone services.

The second tendency, the tendency to keep the executive equipment small and simple, is as old as the Republic. Originally there was comparatively little to coordinate, and the fear of the trappings of a monarchy was a strong influence in creating the praiseworthy tradition of simplicity in the executive mansion. In our time other influences have been at work to deprive the President of some of the elementary tools of coordination that a business executive or military commander finds indispensable. Nobody wants to be coordinated, and appropriations could always be secured for benefit programs, but only with difficulty for over-all management. For years, the White House has been compelled to beg and borrow stenographers by the dozens from the various departments to handle the unprecedented flood of Presidential mail because it cannot get the appropriations required to create its own staff.

However, there are hopeful counter trends at work, and I shall now describe briefly how they have begun to bring order out of the chaos of the executive branch, first by simplifying the structure and second by establishing executive tools of management.

Experienced members of Congress realize the necessity for simplification of the structure of the executive branch. They also realize that it will not come about unless left to executive initiative. Consequently, under the Economy Acts of 1932 and 1933, President Hoover and President Roosevelt were given the authority to initiate mergers which took effect after sixty days unless overruled by both Houses. The same technique was substantially followed in the Reorganization Act of 1939 (Public No. 19, 76th Congress, 1st Session). Comparatively few mergers were accomplished in 1932 and 1933, probably due to the fact that the bank closings and the national emergency took attention from administrative problems and focused it on new programs of relief and reconstruction. However, it was in March, 1933, that the Farm Credit Administration was formed by amalgamation of all the then existing rural lending agencies; amalgamation of the purchasing functions in the Procurement Division and the disbursing functions in the Treasury were accomplished; and the old Shipping Board was abolished and its functions assigned to the Department of Commerce.

In January, 1937, the President sent up to Congress his reorganization message and transmitted the report of his Committee on Administrative Management. The first bill, the 1938 measure, was narrowly defeated as a result of a very emotional and misleading campaign which raised the false cry of "dictatorship." The Reorganization Act of 1939 finally emerged, granting more limited powers than the Economy Acts of 1932 and 1933 had granted to President Hoover and Roosevelt and exempting a great number of agencies. Two plans of reorganization have already been promulgated under the Reorganization Act of 1939 by the President, one on April 25 and the other on May 9. Both were accepted by Congress and have taken effect. Numerous scattered activities were consolidated in three great new coordinating agencies of government, comparable in many respects with cabinet departments. The heads of these

three new agencies now actually attend cabinet meetings. They are the Federal Security Agency, the Federal Works Agency, and the Federal Loan Agency.

The *Federal Security Agency* received the following then independent establishments: (1) The Social Security Board and (2) the Civilian Conservation Corps. It also merged the other principal welfare, education, and health functions as follows:

(1) The U. S. Employment Service from the Department of Labor for coordination with the unemployment compensation functions of the Social Security Board;
(2) The Office of Education from the Department of the Interior;
(3) The National Youth Administration from the old Works Progress Administration;
(4) The U. S. Public Health Service from the Treasury Department.

The *Federal Works Agency* received the following independent activities: (1) The Federal Emergency Administration of Public Works; (2) The Work Projects Administration. It also received other civilian public works functions such as:

(1) The U. S. Housing Authority from the Department of the Interior;
(2) The Bureau of Public Roads from the Department of Agriculture;
(3) Public Buildings functions from the Departments of the Treasury and Interior.

The *Federal Loan Agency* received supervision of the following independent agencies:

(1) Reconstruction Finance Corporation and associated agencies (the RFC Mortgage Company, Electric Home and Farm Authority, Disaster Loan Corporation, Federal National Mortgage Association);
(2) Federal Home Loan Bank Board and group (Home Owners' Loan Corporation and Federal Savings and Loan Insurance Corporation);
(3) Federal Housing Administration;
(4) Import-Export Bank of Washington.

The Farm Credit Administration, including the Federal Farm Mortgage Corporation, the Commodity Credit Corporation, and the Rural Electrification Administration, was transferred to the Department of Agriculture.

A number of agencies were abolished, such as the National Bituminous Coal Commission, the affairs of which are to be wound up by the Secretary of the Interior. The foreign services of Commerce and Agriculture were transferred to the Department of State. The Bureau of Lighthouses was consolidated with the Coast Guard. The Department of the Interior added to its conservation functions by receiving the Bureau of Fisheries from Commerce and the Bureau of Biological Survey from Agriculture. A number of other functions were transferred, but I have mentioned enough, I believe, to show that a great deal was accomplished not only to reduce the number of independent agencies, but to present a more logical arrangement of major functions. The new issue of the *U. S. Government Manual* for October 1939, is the first edition which records these changes. According to this volume (p. 473), twenty major agencies, formerly independent, have been abolished or consolidated into one of the ten existing cabinet departments or one of three new major administrative agencies. The span of control of the Chief Executive has in these cases thus been reduced from thirty to thirteen immediately reporting agencies. To be sure, there are still twenty-four independent establishments listed which were not affected by reorganization and of which not over ten can be properly classified as subject to exemption on the ground that their functions are quasi-judicial. But nevertheless considerable progress has been made in the direction of what I like to call an "administrative short ballot." Coordination of policy and procedure among many vast and complex programs has been made possible, thus freeing Presidential energy for consideration of major problems of national significance. Many of

the transfers were controversial, and the President himself stated that some of them might well be reviewed after a trial period of experience. But there can hardly be controversy over the improvement in the general accountability of the executive branch to the chief executive that will in time be effected by a pattern that is at least possible for the mind to encompass.

Now as to over-all management, the second means by which the Chief Executive may be implemented. Every President in this century has gone on record concerning the need for improvements in governmental efficiency and coordination. It is my opinion that the great landmarks of over-all management in the Government have been the Civil Service Act of 1883, the Act Creating the Bureau of Efficiency of 1913, the Budget and Accounting Act of 1921, and the Classification Act of 1923. The Civil Service Act laid the groundwork for over-all personnel management on the basis of accountability to the Government by prohibiting appointments based on patronage, which breed loyalty only to the special interests to whom appointees are beholden for their jobs. One of the great administrative needs is to increase the number of positions (about one-third of the total) still exempt from civil-service provisions. The old Bureau of Efficiency was the first recognized effect of continuous study of Government organization and procedure from one central point and taught the invaluable lesson that certain administrative problems run throughout all the services. The Budget and Accounting Act of 1921 resulted from many years of study of governmental management and created the office of Director of the Budget, responsible to the President, and laid the groundwork for responsible over-all management through a consolidated executive budget, but it did not succeed in providing us with an effective modern system of accounting and audit. The Classification Act of 1923 recognized the principle of a general civil service granting equal pay for equal work no matter where in the Government a job was located and measurably improved the budget process of eliminating hours of haggling over individual salaries in the departments and in the hearings of appropriation committees. We are prone to forget the budgetary significance of the Classification Act because today we have come to think of it only in its personnel phases. Other general managerial functions which have been merged to the benefit of the general Government are purchasing of supplies, governmental buildings and space control, disbursing, and the housing of valuable records.

The report of the President's Committee on Administrative Management carried the idea of over-all management a step further. It asserted that there were three over-all modern managerial arms that were indispensable for executive control and that these were the arms of budget and efficiency research, of personnel, and of planning. This conception was substantially carried out in the First Reorganization Plan of 1939 and further implemented and defined in the Executive Order which took effect September 11, 1939. In addition to the White House staff recently augmented by the appointment of several administrative assistants, the Executive Office of the President, conveniently located in the State Department Building, now consists of certain divisions which at long last give some tools for the huge task of coordination and administrative management which we expect of the man we elect every four years to occupy the White House.

The Bureau of the Budget, the first of these arms, has been moved from the Treasury Department and has been ex-

panded in personnel to carry out many of the functions which have long been expected of it. In addition to its previous function of supervising and controlling the administration of the budget and acting as a clearing house on new legislation, it has assumed the important function of continuous management and efficiency research throughout the executive branch. A division of administrative management has been created to resume the work which was unfortunately interrupted when the Bureau of Efficiency was abolished in 1933, but perhaps on a little broader scale and with the added advantage of being located in the Executive office. This is a recognition of the need for continuous scrutiny of governmental organization in a fast-moving scene, for continuous adjustments of governmental structure to changing national needs.

On the personnel side, certain interesting developments should be recorded. In June, 1938, the President extended the civil service by Executive Order, required all departments and agencies to appoint technically competent personnel officers, and formed the Council of Personnel Administration for improvement of personnel procedures by an exchange of experience among the departments and representatives of the Civil Service Commission. The Reorganization Act of 1939 prevented any change in the structure of the Civil Service Commission itself. However, the President cannot escape his responsibility for personnel management. The appointing power is in the President; he promulgates the civil-service rules; and furthermore, personnel is the heart of administration. Consequently, he created as part of the Executive Office of the President the Liaison Office for Personnel Management and designated one of his administrative assistants, a career man of thirty years of distinguished Government service, to take charge of this office. Among other duties, this officer is serving as a member of the novel President's Committee on Civil Service Improvement which numbers two Justices of the Supreme Court among its members and which is studying particularly the problems of the technical, professional, and administrative positions in the Federal service.

The third division of the Executive Office is the National Resources Planning Board. This agency studies and recommends long-time plans and programs for the fullest development of our national resources, aids in developing an orderly program of public works, informs the President of the general trend of economic conditions and recommends measures leading to their stabilization, and acts as a clearing house and means of coordination for planning activities. This Board is continuing to use the interesting device used by its predecessor, the National Resources Committee. Its subcommittees span common interests among the departments and in their deliberations are stimuli to breadth of view and a counter to departmental particularism. I am sure all of you are familiar with some of the splendid reports issued from time to time by this body.

Certain other functions have been placed in the Executive Office including the coordination of Government statistics in the Bureau of the Budget and the preparation of public reports and publicity summaries in the Office of Government Reports—but time does not permit me to describe these in detail.

Coming back now from this narrative to the general theme of accountability, it seems to me that a great deal of progress has been made: first, toward creating a simple and more workable Federal structure, and second, toward providing the general manager with necessary tools of over-all management to counteract the

centrifugal tendencies of the Federal flywheel. A central staff has been provided for the Chief Executive so that problems coming to him can be examined from all points of view and not simply from the point of view of a single agency or group. In other words, a beginning has been made of making the executive branch accountable to the general executive.

I shall be brief on the even more important problem of executive accountability to the Congress by simply reporting no progress. The Reorganization Act of 1938 was denounced for its so-called dictatorial features and defeated although it contained a provision, requested by the President, for an independent audit of the affairs of the executive branch and the creation of a Joint Committee of both Houses to receive and scrutinize its reports. I believe this subject will be treated by another speaker, but let me say that this is the one big item of unfinished business of accountability in Federal administration—a proper reallocation of the functions of accounting, settlement, control, and audit between the executive and legislative branches.

The problem of maintaining and improving accountability in our Federal Government is one that requires continuous vigilance and a strong concentration on the importance of balance in our administration as well as in our entire national life. The democratic system if properly implemented should assure this balance because of its guarantees of freedom of expression, of responsiveness and compromise in the legislative process, and of continuity and coordination in the executive process. One of the dangers we seldom contemplate is the danger that one particular interest group should attain a position of dominance, even with the best of motives, and inadvertently threaten thereby the balance and accountability in the general welfare to which we are committed.

It may be reducing the argument to an absurdity, but I shall take an extreme example of what happens when one interest in government becomes so powerful that it takes over the whole show. I think of Mr. Thyssen, the industrialist now sitting in Switzerland who supported National Socialism so that Germany would be dominated by big business, reflecting that he got a despotism that is not accountable to anybody and which is apparently ruining not only German capitalistic industry but Germany itself. And then I think of Mr. Trotzky, now sitting in Mexico, who wanted a government only for labor and who is getting another kind of irresponsible despotism, accountable to nobody and sacrificing labor to power politics. This is particularism run riot and is referred to parenthetically as an admonition to those who resent the so-called inefficiency of free democratic institutions where the legislature elected by all the people is our protection against particularism in policy and where the general executive is the accountable protection against particularism in administration. There is no efficiency in despotism in the modern technological world because it lacks the element of organized accountability which is the saving element of sanity that prevents government from madness and self-destruction.

It is for these reasons that I regard recent administrative trends in the Federal Government as of major importance because they are, in my opinion, a great step forward in operating our free institutions. They are a move counter to particularism and in the direction of better coordination and accountability, and they demonstrate that efficiency is compatible with democracy.

FEDERAL ACCOUNTKEEPING

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DEPARTMENTAL ESTIMATES

BEFORE a department or agency of the Federal Government can obtain funds it must convince the Federal Bureau of the Budget, the President, and Congress, that the amounts requested are necessary. Planning is based on the financial period beginning July 1 of a particular calendar year and ending June 30 of the succeeding calendar year. This period is always referred to as the "fiscal" year, and is given the number of the calendar year in which it ends. For example, the fiscal year beginning July 1, 1939 and ending June 30, 1940 is known as the fiscal year 1940. The Budget and Accounting Act in Section 215 requires that:

> The head of each department and establishment shall revise the departmental estimates and submit them to the Bureau on or before September 15 of each year. . . . (42 Stat. 20).

This provision of law has reference to the submission of the departmental estimates to the Federal Bureau of the Budget for the fiscal year which will begin July 1 of the following calender year. There is thus an interval of nine and one-half months for the consideration of the estimates by the Federal Bureau of the Budget, the President, and Congress. Before a department can submit its estimates in finished form, however, months of preparation are required. The instructions relative to the preparation of estimates of appropriations for the fiscal year 1941, for example, were sent to the bureaus of the Departments in the spring of 1939.

The agencies of the Federal government obtain their funds almost exclusively through appropriation by Congress. Even the Treasury Department which collects most of the governmental income, cannot spend its collections until Congress passes an appropriation act. This restriction arises from the Constitution which provides in the seventh clause of Section 9 of Article I as follows:

> No money shall be drawn from the Treasury but in consequence of appropriations made by law; . . .

Typically, the Federal bureaus are organized into divisions and sections. Budget preparation for a fiscal year begins in the section. The chief of the section estimates as best he can for the fiscal year under consideration (which is more than a year in the future from the time he is doing the planning) how much it will cost to do the work with the personnel, materials, services and equipment needed. Increases or decreases as compared with the year in progress, which is the fiscal year for which appropriations have been most recently enacted, must be explained fully.

In each bureau an employee is designated as budget officer and is charged with combining the estimates, studying them, and making such recommendations to the head of the bureau as seem most appropriate. In addition, this employee is responsible for the preparation of routine and special budget reports.

The budget work of the departments is, of course, more important and more difficult than that of the bureaus. The Budget and Accounting Act, 1921, contains the following special provision on the subject:

> Sec. 214. (a) The head of each department and establishment shall designate an official thereof as budget officer therefore, who, in each year under his direction and on or before a date fixed by him, shall prepare the departmental estimates.
>
> (b) Such budget officer shall also prepare, under the direction of the head of the department or establishment, such supplemental and deficiency estimates as may be required for its work.

The bureaus are required to report actual operations of the last completed fiscal year, actual and estimated operations for the fiscal year in progress, and requests for the succeeding fiscal year. Information on past results is obtained from the accounting system. The estimated requirements are determined by the bureau plans for the future, and the probable limits of funds available or reasonably expected to be made available by Congress.

When the bureau estimates are received by the departmental budget officer, a careful study of the estimates is made and hearings with bureau officials are held. After necessary modifications, the bureau estimates are combined to form the estimates for the department as a whole, and forwarded not later than September 15 to the Federal Bureau of the Budget. The departmental requests are accompanied by detailed narrative explanations, statements, tables and charts.

RELATIONS WITH THE BUREAU OF THE BUDGET

The Bureau of the Budget is furnished estimates pertaining to each appropriation, in the following documents:

1. A summary which presents a list of items constituting changes in amounts as compared with preceding periods.
2. The appropriation language and amounts with contemplated changes clearly indicated.
3. An analysis of expenditures by objects.
   a. Actual expenditures for the last completed fiscal year.
   b. Actual and estimated expenditures for the year in progress.
   c. Estimated expenditures for the ensuing fiscal year.
4. A justification and explanation of the need for appropriation setting forth the results to be accomplished and the advantage to be derived by the Government through enactment of the appropriation.

Personal services are reported according to the standard classification of positions used by the Government. The number of employees in each grade and the average salaries are shown.

The Bureau has been endeavoring to obtain definite information to enable it to pass more scientifically on the estimates. The following extracts are taken from a recent budget circular:

> A general paragraph in explanation of the entire amount of the increase in an estimate of appropriation while desirable as an introductory paragraph, cannot usually be accepted as a substitute for a detailed justification of the component parts of the increase. Following such an introductory paragraph, and in the order of the tabular itemization of the increase, there should be a separate justification of each of the listed items of increase. . . .
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> Where the volume of work performed under the appropriation is susceptible to measurement, in whole or in part, a table should be presented, showing, by appropriate units of measurement, the volume of work during each year of the period, . . .

The Bureau of the Budget under the direction of the President studies the departmental requests for appropriations and holds extensive hearings. The knowledge obtained from the estimates and through the hearings is not the only information available to the Budget staff. Investigators are constantly in touch with the bureaus and departments and are gathering data throughout the year so that they have standards with which to measure and judge requests for appropriations. On the basis of the requests, the information previously obtained, and the additional information developed at the hearings, the expenditure program is correlated with prospective collections. Necessary changes in revenue laws or acts relating to expenditures are drafted by the departments or the Bureau of the Budget. When a balanced program has been completed for the fiscal year under consideration, the Budget Document is

prepared and submitted to Congress by the President.

The Federal Bureau of the Budget sometimes reduces departmental requests for appropriations. Should this occur, the departments are precluded from appealing to Congress for increases over the President's recommendations. The only chance of obtaining an increase is for Congress to initiate action. This limitation is prescribed by Section 206 of the Budget and Accounting Act, 1921 (42 Stat. 20):

Sec. 206. No estimate or request for an appropriation and no request for an increase in an item of any such estimate or request, and no recommendation as to how the revenue needs of the Government should be met, shall be submitted to Congress or any committee thereof by any officer or employee of any department or establishment, unless at the request of either House of Congress.

RELATIONS WITH CONGRESSIONAL APPROPRIATION COMMITTEES

When the Budget Document is received by Congress, copies are referred to the appropriation committees of the House and of the Senate. The committees are divided into subcommittees which hold hearings on particular departments. House appropriation hearings are usually held before those of the Senate. The Secretary of the department and the departmental budget officer appear first and make general statements on departmental policy respecting financial and activity programs. Later, other representatives of the bureaus of the department are called before the subcommittee and interrogated at length. From the information contained in the Budget and developed at the hearings, the subcommittee determines the amounts, which in its own judgment should be appropriated for carrying on the activities of the department and drafts an appropriation bill to carry its judgment into effect. The appropriation committee considers the proposed bill prepared by the subcommittee and adopts it after making any changes considered desirable. The Committee then reports the bill to the House.

When the House is ready to discuss an appropriation bill, it goes into the Committee of the Whole House on the State of the Union in order to simplify and expedite debate and amendment. That committee, when it has finished its work on the bill reports it to the House, together with any amendments the Committee has added. The House usually passes the bill as it was finally approved by the Committee of the Whole.

The House appropriation bill is forwarded to the Senate where it is referred to the Committee on Appropriations and then to the subcommittee in charge of the appropriations for the particular department. The Senate hearings are usually not as extensive as those of the House—one reason for this may be that the data obtained by the House are available to the Senate and therefore less investigation by the latter body is necessary. On occasion, however, the Senate hearings may be so extended that the printed record of the hearings of a large department will fill a volume of several hundred pages. Upon completion of its hearings the Senate subcommittee drafts modifications to make the appropriation bill conform to its ideas. The bill is then considered by the full Senate committee and reported to the Senate together with amendments drafted by the committee. The Senate considers the House bill, the committee amendments, and amendments which Senators offer from the floor. After explanation and debate the bill is amended, passed by the Senate and printed.

Senate changes require that a conference committee be appointed to reconcile the difference between the two Houses. The members of the conference committee are designated by the Vice-President and

the Speaker of the House and are usually selected from the appropriation subcommittees. The conference committee attempts to reach an agreement on the bill and reports its findings to the two Houses. If the conference report is adopted by both Houses, Congress has finished its work on the appropriation bill. The bill is enrolled and then forwarded to the President for approval.

Inasmuch as the bill has usually been changed from the recommendations of the President and of the Department, the President forwards the bill to the Federal Bureau of the Budget and to the Department before he approves it. If adverse recommendations are not made by these agencies, the President usually approves the bill and it becomes law.

THE ALLOTMENTS

Planning the Expenditures

The appropriation act is forwarded to the Department of State which certifies copies to the Treasury Department. The latter Department prepares an appropriation warrant and transmits it to the General Accounting Office, which countersigns the warrant and returns it to the Treasury. Appropriation accounts are maintained by both organizations.

The Treasury sends copies of the appropriation warrants to the departments which notify the bureaus as to the contents of the warrants. Accounts for appropriations are opened on the books of the department and of the bureaus.

Before the bureaus begin spending they are required to plan their expenditure programs by months during the fiscal year so that the Government as a whole may arrange its financial program to best advantage. They forward reports of prospective obligations, called apportionments of funds, to the departmental budget officer who reviews and if necessary modifies the apportionments and forwards them to the Federal Bureau of the Budget. That Bureau reviews, and approves the apportionments, with such changes as it sees fit to make. It notifies the departmental budget officer who in turn informs the bureaus as to the amounts approved.

The information thus obtained enables the Government to make accurate plans and to have funds available when and where disbursements are necessary. Another advantage is that the Government, by having definite knowledge, will not borrow large sums and pay interest thereon before the funds are needed.

Allotting the Appropriations

The official in charge of the expenditure of an appropriation is usually the head of the bureau. When he receives notice of an appropriation he divides it into parts known as allotments. The allotments may be made on the basis of organization units, projects, or particular lines of work, or for specific purposes such as salaries, traveling expenses and office supplies. In any event, the head of an organization unit, usually the chief of a division or of a section, is definitely charged with responsibility for each allotment. An effort is made to prevent any organization unit from exceeding any of the allotments for which it is responsible, an objective which if achieved, will naturally prevent overexpenditure of the total appropriation.

The bureau head will not usually allot the entire appropriation but will hold an amount in the unallotted balances. He may allot funds to the divisions which the division chiefs will reallot to the sections under their supervision. The division chiefs, in turn, will probably reserve a portion of the allotments before reallotting. The purpose of the reserves is to take care of unexpected changes in the volume of work and to permit financial adjustments that become necessary during the fiscal period. Of course, the section

chiefs cannot plan a full program if their funds are curtailed. Attempts to proceed with a complete program in the hope that more funds may be available at a later date either from the reserves or from savings in other allotments will cause overencumbrance of allotments which may then lead to overexpenditure of appropriations and attending dire consequences. Specifically, these dire consequences are: immediate removal from Government service, and fine or imprisonment, or both.

It is probably better to use a system of reserves which will avoid as much as possible disruption of work because of withdrawal of parts of allotments already made. In a large bureau with extensive financial operations, even under the best possible planning, recall of expenditure authorizations will sometimes occur.

Encumbering Allotments

All charges definitely ascertained at the beginning of the year are entered as a reduction of the unemcumbered balance of allotments as of July 1. Illustrations of such items are salaries, rents and contracts. Other encumbrances, such as purchase orders, are recorded when the obligation is incurred. Thus, the government makes a regular practice of entering contingent liabilities currently.

There are two reasons for this precaution on the part of the government: first, overexpenditure of appropriations is prohibited by law; second, if a division of a bureau expends its money before the end of the year, it cannot go to the bank and borrow money. Therefore, the encumbrance procedure is of vital importance.

Liquidating Encumbrances

When the encumbrances become due they are liquidated by means of disbursement vouchers. The disbursement voucher does not cause any change in the unencumbered balance of the allotment, since the allotment was reduced when the encumbrance was set up, unless the amount of the voucher is more or less than the amount encumbered. If the voucher is less than the encumbrance which it liquidates, the unemcumbered balance of the allotment is increased. Should the voucher be greater than the encumbrance it covers, the unencumbered balance of the allotment must be reduced.

Vouchers are audited or "examined" by auditors to ascertain that they are proper charges against the allotments and appropriations and that the goods or services covered by the vouchers have been received. If the examination proves the proposed expenditures to be proper, each disbursement voucher is approved by a duly designated and authorized official known as the "certifying officer." This officer is responsible for the propriety of the expenditures and availability of funds to pay the vouchers certified.

BOOK RECORDS OF BUDGET FIGURES

Section 309 of the Budget and Accounting Act, 1921 (42 Stat. 20), directed the Comptroller General of the United States to "prescribe the forms, system and procedure for administrative appropriation and fund accounting in the several departments and establishments." After a period of study and experimentation, the General Accounting Office installed an accounting system based on handwritten records in two bureaus. At the end of a year of hand operation the system was adapted to accounting machines and gradually extended to other bureaus.

The first order or regulation issued for general application was Circular Letter No. 27 dated July 21, 1926. This letter transmitted a list and description of general-ledger accounts based on double-entry principles for consideration by the departments and establishments and asked that suggestions concerning the proposed

system be sent to the General Accounting Office. No formal changes relating to the general ledger accounts for the entire government have been prescribed since the issuance of Circular Letter No. 27. However, the Office maintains a list of general-ledger accounts for use in prescribing a system for a department or an establishment. The list as published in the 1937 Annual Report of the Acting Comptroller General is as follows:

Uniform Accounting System—General-Ledger Accounts

01. Treasury cash (by symbols and titles)
02. Available cash (by symbols and titles)
03.31 Disbursing Officers' cash—Disbursing funds (by symbols and titles)
03.32 Disbursing Officers' cash—Receipts and repayments (by symbols and titles)
03.37 Disbursing Officers' cash—Special deposits
04. Securities—Special deposits
05. General funds receipts deposited (by sym-(bols and titles)
06. Special and trust fund receipts deposited (by symbols and titles)
07. Retirement and disability funds
08.1 Investments
08.11 Accrued interest receivable on investments
08.6 Investments—Trust funds (by trusts)
08.61 Accrued interest receivable on investments —Trust funds (by trusts)
9.1 Loans receivable
09.11 Accrued interest receivable on loans
09.6 Loans receivable—Trust funds (by trusts)
09.61 Accrued interest receivable on loans—Trust funds (by trusts)
10.1 Accounts receivable
10.6 Accounts receivable—Trust funds
11.1 Unmatured collection contracts
11.11 Estimated returns—Unmatured collection contracts
11.6 Unmatured collection contracts—Trust funds
11.61 Estimated returns unmatured collection contracts—Trust funds
15. Estimated receipts for appropriation (by symbols and titles)
20.1 Stores
20.6 Stores—Trust funds
22.1 Freight and handling—Adjustment Account
22.6 Freight and handling—Adjustment Account—Trust funds
30.1 Fixed property
30.11 Fixed property depreciation reserve
30.6 Fixed property—Trust funds
30.61 Fixed property depreciation reserve—Trust funds
33.1 Equipment
33.11 Equipment depreciation reserve
33.6 Equipment Trust funds
33.61 Equipment depreciation reserve—Trust funds
38.1 Work in process
38.6 Work in process—Trust funds
39.1 Undistributed Expenditures
39.6 Undistributed Expenditures—Trust funds
40.1 Current costs
40.6 Current costs—Trust funds
50.1 Operating reimbursable earnings
50.6 Operating reimbursable earnings—Trust funds
60.1 Unvouchered invoices payable
60.6 Unvouchered invoices payable—Trust funds
64.1 Retirement contributions—Civil Service Commission Form 2806
64.11 Retirement contributions—Pay card
66. Unapplied special deposit collections
69. Trust obligations (by trusts)
69.1 Unallotted trust appropriations (by symbols and titles)
69.2 Unencumbered trust allotments
69.3 Unliquidated trust encumbrances
69.4 Expended trust appropriations
69.41 Reimbursements to trust appropriations
70. General fund receipts (by symbols and titles)
72. Accrued income for appropriation (by symbols and titles)
80. Capital stock
80.1 Surplus
80.2 Profit and loss
90. Invested and donated capital
91.1 Unallotted appropriations (by symbols and titles)
91.2 Unencumbered allotments
91.3 Unliquidated encumbrances
91.4 Expended appropriations
91.41 Reimbursements to appropriations

Ledger Forms

Two ledgers are used, the general ledger and the allotment ledger. The general ledger is arranged as follows:

A. Heading with space for numerical code symbol and title of the ledger account

B. Vertical columns
   1. Previous balance
   2. Account symbol
   3. Date
   4. Description
   5. Debit
   6. Credit
   7. Memorandum
   8. Balance

The general-ledger form is similar to the ordinary type of ledger used in mechanical accounting for private business organizations and needs no explanation.

The allotment ledger is arranged as follows:

A. Heading with space for numerical code symbol and title of the allotment account
B. Vertical columns
   1. Previous balance
   2. Symbol
   3. Date
   4. Reference number
   5. Description
   6. Blank column—for use as bureau sees fit
   7. Audited vouchers
   8. Encumbrances liquidated
   9. Encumbrances authorized
   10. Blank column—for use as bureau sees fit
   11. Allotments
   12. Unencumbered balance of allotment

The Allotment Ledger

The greater portion of the accounting work is done on the allotment ledger. It is important not only from the standpoint of the volume of work done upon it, but also from the variety of valuable information it presents. The headings of columns No. 1 to No. 5, inclusive, are self-explanatory. Columns No. 6 and No. 10 are left blank to be used for accumulating any data desired by the bureaus which are not provided by the other columns. The following columns require a brief description:

7. Audited vouchers
8. Encumbrances liquidated
9. Encumbrances authorized
11. Allotments
12. Unencumbered balance of allotment

From a chronological viewpoint these columns are affected in the following order:

(a) Column No. 11 Allotments
(b) Column No. 12 Unencumbered balance of allotment
(c) Column No. 9 Encumbrances authorized
(d) Column No. 7 Audited vouchers
(e) Column No. 8 Encumbrances liquidated

A discussion of these columns can, perhaps, be more easily followed if presented in the order of the chronological sequence of the transactions entered.

Allotments Column

The allotments column is a plus column. The allotment advices are entered here and establish or increase the unencumbered balance of the allotment.

Unencumbered Balance of Allotment Column

The column, unencumbered balance of allotment, is a balance column and is the net result of the increases and decreases of the other columns of the sheet. In effect, the unencumbered balance of allotment is a credit account. The total of all the unencumbered balance of allotment columns on all the allotment sheets should agree with the account "Unencumbered Allotments" in the general ledger.

Encumbrances-Authorized Column

The encumbrances-authorized column is a minus column. In it are entered all encumbrances against the allotment which reduce the amount in the unencumbered-balance-of-allotment column.

Audited-Vouchers Column

The amount of each approved voucher is entered in the audited-vouchers column. The entries reduce the unencumbered balances of allotments.

Encumbrances-Liquidated Column

The encumbrances-liquidated column is a plus column and entries therein increase the unencumbered balance of allotment. When a voucher is entered in the audited-vouchers column an entry in the encumbrances-liquidated column immediately follows for the amount of the encumbrance which the voucher is liquidating. It sometimes happens that a voucher is being paid for which no previous encumbrance has been set up. In such event, no entry is made in the encumbrances-liquidated column.

Blank Columns

Columns 6 and 10 are blank. They may be used for accumulating any data the bureau desires. Column No. 6 might be used for entry of vouchers sent to the General Accounting Office for direct settlement. Transactions pertaining to stores issues may be recorded in column No. 10. Entries would be made to credit the storeroom allotment and charge the allotments of the operating division receiving the stores.

Direct-Settlement Vouchers

In case column 6 is used for direct-settlement vouchers, which is the term used to designate vouchers to be settled by the General Accounting Office, the entries reduce the unencumbered balance of the allotment.

Stores Issues

When column 10 is used to record stores issues it becomes a minus column. Cash or stores, or both, may constitute a fixed amount of capital which is to be employed on a revolving-fund basis. Under such arrangement, the storeroom is allowed to purchase only as it issues. When goods are issued, the storeroom may purchase other goods of equal vaue. Issues are charged to the allotment of the operating division, which receives them, and the storeroom allotment account is credited. There is no exchange of cash in connection with the transaction. Adjustment is made by book entries only. As purchases are made by the storeroom its allotment is decreased. No purchases can be made unless there is a balance in the allotment account. This procedure tends to promote economy since the consumption of supplies causes as much decrease in the allotments of the operating division as the expenditure of cash. Where this procedure or a similar one is not used, the employees would not have as much pressure upon them to use supplies in the most economical manner. As stated above, the stores issues column is a minus column. Charges to the operating divisions are entered in black and decrease the unencumbered balances of allotments of those divisions. The credits to the storeroom allotment for goods issued are entered in the column in red ink (or contra) which has the effect of a plus entry, which increases storeroom allotment.

The cost of operating the storeroom may be financed by allotments made directly from one or more appropriations or by an additional charge placed on goods issued to the operating divisions. In the latter event the operating divisions would be billed for supplies and equipment at amounts in excess of the purchase price.

Summarizing the Allotment Ledger

The allotment ledger sheets are totaled at the end of each month, and the allotments under each appropriation are summarized on an allotment ledger form. The postings are then made from the summary sheet, which is called "Summary of Allotment Ledger Transactions." Where machines are used which can prepare a register by carbon process, the work of summarizing the allotment ledger is avoided because postings may be made from the carbon register sheet on which the allotment ledger entries have been accumu-

lated throughout the month. The register is called the "Register of Allotment Ledger Transactions." The totals of the columns of the Summary of the Allotment Ledger Transactions (or the Register of Allotment Ledger Transactions) are posted to the General Ledger accounts as follows:

1. From the Allotments Column
   Debit: 91.1 Unallotted Appropriations
   Credit: 91.2 Unencumbered Allotments
2. From the Encumbrances-Authorized Column
   Debit: 91.2 Unencumbered Allotments
   Credit: 91.3 Unliquidated Encumbrances
3. From the Audited-Vouchers Column
   Debit: 91.2 Unencumbered Allotments
   Credit: 91.4 Expended Appropriations
4. From the Encumbrances-Liquidated Column
   Debit: 91.3 Unliquidated Encumbrances
   Credit: 91.2 Unencumbered Allotments
5. From the Direct-Settlements Vouchers Column
   Debit: 91.2 Unencumbered Allotments
   Credit: 91.4 Expended Appropriations
6. The Stores-Issues Column
   Stores issued have been entered on one allotment sheet as a minus quantity and on another as a plus quantity. Therefore, there is no column total to be posted from the Summary of Allotment Ledger Transactions to the General Ledger.

USE OF TREASURY AS DISBURSING AGENT

Most disbursing officers are not under the supervision of the spending departments, but are officials of the Treasury Department. Before 1933 disbursing officers were usually under the jurisdiction of the departments. They were bonded to the Government and in addition were liable, to the full extent of all property owned by them, for improper payments. Theoretically, each officer was free to determine what disbursements were proper. However, he was under considerable pressure from his department to pay promptly all vouchers presented to him in order to avoid obstructing departmental programs. If his superior officers believed that he caused too much delay in endeavoring to protect himself, he was subject to demotion or dismissal. Consequently, many vouchers were paid which were disallowed by the General Accounting Office and charged to the disbursing officers. Congress would usually grant legislative relief for disallowed disbursements made in good faith. However, there were many cases where the officers sustained losses and there was never any definite assurance that Congress would grant relief. An additional disadvantage of the departmental system was that a great deal of time was required to assemble information for financial reports for the Government as a whole. To correct these shortcomings of the disbursement system and to provide greater uniformity in recording and reporting expenditures, there was included in Executive Order No. 6166, dated June 10, 1933, the following section pertaining to disbursements:[1]

> The function of disbursement of moneys of the United States exercised by any agency is transferred to the Treasury Department, and, together with the office of the Disbursing Clerk of that department, is consolidated in a Division of Disbursement, at the head of which shall be a Chief Disbursing Officer.
>
> The Division of Disbursement of the Treasury Department is authorized to establish local offices or to delegate the exercise of its functions locally to officers or employees of other agencies, according as the interests of efficiency and economy may require.
>
> The Division of Disbursement shall disburse moneys only upon the certification of persons by law duly authorized to incur obligations upon behalf of the United States. The function of accountability for improper certification shall be transferred to such persons, and no disbursing officer shall be held accountable therefore.

Before vouchers are forwarded to a disbursing officer for payment, a requisition is prepared for funds to be placed to the credit of a disbursing officer. The requisi-

[1] The order was issued pursuant to the Act of March 3, 1933 (47 Stat. 1517) which provided for the grouping, coördinating and consolidating of executive administrative agencies.

tion is transmitted to the General Accounting Office, which approves it and sends it to the Treasury Department where a document known as an accountable warrant is drawn and submitted to the General Accounting Office for counter-signature. Then the warrant is forwarded to the Treasurer of the United States who places funds to the credit of the disbursing officer.

Bureaus may now route disbursement vouchers to the disbursing officer. When that officer receives the vouchers he examines them to see that they are signed by certifying officers who have authority to incur charges against the funds which have been advanced. If the vouchers are in order, checks are drawn and mailed or otherwise delivered to the payees. The checks are cashed through the banking system and returned to the Treasurer of the United States. Eventually, all vouchers and checks are forwarded to the General Accounting Office for auditing and permanent retention.

MONTHLY AND ANNUAL FINANCIAL STATEMENTS AND REPORTS

In recent years the fact has been emphasized that the chief reason for which governmental accounts are kept is that they may serve as a basis for the preparation of financial statements. A second purpose which can be accomplished as a result of developing the informational aspects of accounting is the determination of the honesty of government officials with respect to government moneys and other resources.

Financial Statements of Federal Bureaus

Because the General Accounting Office has authority to prescribe accounting and reporting and, in the case of the bureaus, has done so, uniformity is approached with respect to bureau financial statements. However, the bureau statements are not usually distributed to the public.

Included in the statements usually prepared are:

1. Statement of Balances—General Ledger Accounts
2. Statements of Allotment Transactions

Statement of Balances—General-Ledger Accounts

A balance sheet is not definitely required by the bureau accounting system. The statement of balances is however, a formal presentation of the trial balance and includes information from which a balance sheet may be prepared. This report shows the cash, accounts receivable, stores, and equipment in the control of the bureau and the operating expenses (current costs) during the fiscal year up to the date of

STATEMENT OF BALANCES
GENERAL-LEDGER ACCOUNTS

Bureau of General Administration
Period Ended July 31, 19__

		Balances	
	Accounts	*Detail*	*Total*
01.	Treasury Cash		
	1001 Salaries	$........	
	1002 General Expenses	....	$........
03.31	Disbursing Officers' Cash—Disbursing Funds		
	1001 Salaries	$........	
	1002 General Expenses	....	....
03.32	Disbursing Officers' Cash—Receipts and Repayments		
	1002 General Expenses	$........	
	5115 Sale of Government Property—All Other	....	....
05.	General Fund Receipts Deposited		
	5115 Sale of Government Property—All Other		....
07.	Retirement and Disability of Funds		....
10.1	Accounts Receivable		....
20.1	Stores		....
33.1	Equipment		....
39.1	Undistributed Expenditures		....
40.1	Current Costs		....
	Total		$........

Accounts	Balances *Detail*	Balances *Total*
64.11 Retirement Contributions—Pay Card...........		$........
70. General Fund Receipts		
5115 Sale of Government Property—All Other..		....
90. Invested and Donated Capital		....
91.1 Unallotted Appropriations		
1001 Salaries...........	$........	
1002 General Expenses..	....	....
91.2 Unencumbered Allotments.		....
91.3 Unliquidated Encumbrances		....
91.4 Expended Appropriations..		....
Total...........		$........

the statement. It also indicates in account "90.1 Unallotted Appropriations" the amount available for making additional allotments. For data relative to allotments and encumbrances the "Statement of Allotment Transactions" shown hereafter is more informative. A pro forma copy of the "Statement of Balances—General-Ledger Accounts" is presented above.

Statement of Allotment Transactions

At least once a month, persons in charge of allotments must receive reports as to obligations, expenditures and balances of their allotments. Such information is obtained from the allotment ledgers and reported in a "Statement of Allotment Transactions." The form of statement is found at the bottom of this page.

Financial Statements of Federal Departments

Only in exceptional cases do the Federal departments issue financial statements in a separate report. Such statements are usually printed as a part of the regular annual report of the department. There is practically no uniformity in the contents or arrangement of the statements.

No central agency of the government has as yet undertaken to prescribe methods of accounting and reporting for the fiscal offices of the departments. However, accounting and reporting work of all bureaus is performed centrally by some of the smaller departments. The Director of Finance of the Department of Agriculture issues an annual report which describes the work performed by the various organization units of the Departmental Office of Budget and Finance, and includes statements of income and expenditures for the Department as a whole.

Statement of Income (Receipts)

The departments and establishments of the Federal Government are primarily spending rather than collecting agencies. The Treasury Department collects most of the revenues. The income of the operating departments, however, amounts to many millions of dollars annually. For example, the income of the Department of Agriculture for the fiscal year 1938 amounted to more than $42,000,000 (Annual Report, Director of Finance, 1938.)

Statement of Expenditures

The nature of the expenditures for a department will depend on the functions and activities assigned to it. The Director of Finance of the Department of Agricul-

BUREAU OF GENERAL ADMINISTRATION

APPROPRIATION 1002, GENERAL EXPENSES, BUREAU OF GENERAL ADMINISTRATION

STATEMENT OF ALLOTMENT TRANSACTIONS FOR THE PERIOD
JULY 1, 19__ TO JULY 31, 19__, INCLUSIVE

Allotments	*Audited Vouchers*	*Encumbrances* *Liquidated*	*Encumbrances* *Authorized*	*Stores Issues*	*Allotments*	*Unencumbered Balances of Allotments*
1002.20 Traveling Expenses...........	....	....	....	....	....	....
1002.21 Freight and Communications....	....	....	....	....	....	....
1002.22 Construction and Repairs.......	....	....	....	....	....	....
1002.23 Storehouse Allotment...........	....	....	....	....	....	....
Totals.................						

ture includes a statement of expenditure in his report. (See pages 3–9, 14–19 of 1938 report.) The statement is divided into two main sections, expenditures from regular funds and expenditures from emergency funds. During the fiscal year 1938, the expenditures from regular funds for agricultural adjustment and related items amounted to about four-sevenths of the total while the next largest group, cost of roads, aggregated about two-sevenths. Under the emergency funds the expenditures for rehabilitation and resettlement consumed most of the amount available.

Financial Statements of the Federal Government

In general the financial statements of a government should include the following:

Statement of Financial Condition

1. A general balance sheet showing in summary form all assets owned, all debts owed and the difference (either net worth or deficit)
2. A current balance sheet containing current assets, current liabilities, and the working capital
3. Various schedules of assets and liabilities

Statement of Financial Operation

1. A Summary Statement of Financial Operation

Statement Classifying Income According To:

1. Sources
2. Organization Units
3. Funds

Statements Classifying Expenditures According To:

1. Funds
2. Appropriations
3. Organization Units
4. Character
5. Objects
6. Functions
7. Activities

The foregoing requirements are already met to a large extent in the reports of the Federal Government.

A brief description of various statements and the publications in which they may be found are presented below.

Statement of Financial Condition

The following statements related to financial condition are published by the United States Government:

1. General Fund Balance Sheet—Current Assets and Liabilities (pages 524–525 of the Annual Report of the Secretary of the Treasury, 1938)
2. Securities Owned by the United States (*Ibid.*, pp. 527–529)
3. Public Debt Outstanding (*Ibid.*, pp. 472–475)

Current assets owned by the Government and the liabilities which presumably will be settled out of such assets are included in the balance sheet. The amount by which assets exceed the liabilities is called the "Balance in General Fund."

In addition to the current balance sheet the securities owned by the Government and the amount of the public debt are reported. It should be kept in mind that they are not current items. However, they have a very important bearing on the financial position of the Government.

Statement of Operations

The statement of financial operation (U. S. Budget, 1940, p. XXI) shows in summary form the sources from which the Government obtains its funds and the principal purposes for which expenditures are made. When complete analyses and classifications are made, the operating statement shows to what extent the Government is keeping within its current income. It is believed that if all expenditures which were made for the acquisition of permanent assets were eliminated from the expenditures, the amount shown as the net deficit would be considerably reduced.

Classification of Income

Income Classified by Sources

A statement of income classified by sources (U. S. Budget, 1940, p. XXII) shows where the Government gets its money, that is the amounts obtained from taxes, including the particular kind of taxes, such as internal revenue and social-security taxes, from customs, interest, sales of services, miscellaneous revenues, and from non-revenue sources, such as borrowings and realization upon assets. Such statements, like any other operating statements, show what has happened in the past, the current trends, and provide a basis of financial planning for the future.

Income Classified by Organization Units and Accounts (Fund Groups)

This statement (page 22 of 1938 edition of the U. S. Treasury Report of Combined Statements of Receipts, Expenditures and Balances) shows income classified by principal organization units of the Federal Government. Income is distributed according to three fund groups (or accounts), namely: general, special and trust accounts. About 98% of the income was collected by the Treasury Department.

Classification of Expenditures

Expenditures Classified by Funds and Appropriations

This "Combined Statement" (pages 113–623 of the 1938 edition of the U. S. Treasury Report of Combined Statement of Receipts, Expenditures and Balances) contains statements relative to funds and appropriations showing in each case:

Unexpended balances June 30, 1937
Appropriations
Expenditures in 1938
Amount carried to surplus fund
Unexpended balances June 30, 1938

As previously indicated in this paper, the Government classifies funds and appropriations according to three so-called accounts (or fund groups), namely, general, special and trust funds. To this may be added the public debt group which makes a total of only four groups for the many and complicated transactions of the Federal Government. Most textbook writers and other authorities suggest as many as eight or ten fund groups for states and cities. It seems that the Federal Government should have a dozen or more groups to insure adequate financial management and more accurate financial reporting.

Expenditures Classified by Organization Units

This statement (pages 103–112 of the 1938 edition of the U. S. Treasury Report of Combined Statement of Receipts, Expenditures and Balances) shows expenditures classified according to the following main headings:

Legislative
Executive Office
Independent Offices
Departments
District of Columbia
Public Debt
Miscellaneous Accounts
Transfers from General Accounts

The Judicial Branch of the Federal Government is not listed separately in this statement, but is reported as a subheading under the Department of Justice with the title, "The Judiciary."

The statement carries the following vertical money columns:

General and special accounts
Recovery and relief accounts
Total, general, special, recovery, and and relief accounts
Trust accounts

Expenditures Classified by Functions

In a very general way the statement of expenditures classified by functions (U. S. Budget, 1940, pp. XXIII–XXIV) shows

how much it costs to carry out the purposes of Government. It shows also whether the Government is actually performing its functions. If no expenditure is shown for a particular function it may be assumed that it is not being performed; all governmental functions cost money.

With respect to the amount of expenditures for the fiscal year 1938, the most important function was recovery and relief. Other important items were civil departments and agencies, national defense, interest on the public debt, and veterans' pensions and benefits.

Expenditures Classified by Character and Object

A statement of expenditures by character and object (U. S. Budget, 1940, p. 912) discloses the types of commodities and services the Government is using or consuming in its operations. Such a statement does not show definitely the function of government for which the commodities are being used. Analysis of expenditures for various organizations will, however, provide a basis for economy and efficiency in operation. If one organization, with respect to its administrative activities is consuming more of a particular commodity or service than another of comparable size and geographical location, it may be possible to reduce the expenditures of the first. However, if the first organization is obtaining better results than the second, an increase of expenditures of the second may be the wisest move to increase efficiency.

Financial Reports

Among the important financial reports issued by the Central Agencies of the Federal Government are the following:

1. The Budget Document
2. Annual Report of the Secretary of the Treasury
3. The Combined Statement of Receipts, Expenditures and Balances
4. Digest of Appropriations
5. Annual Report of the General Accounting Office
6. Report of Emergency Funds
7. Daily Statement of the U. S. Treasury
8. The Public Debt Statement

The Budget Document

The Budget is, in effect, an annual financial report showing the financial operations and the financial condition resulting from operation. It covers the financial work of the last fiscal year which has been completed, the actual and estimated results of the year in progress at the time the Budget is submitted, and includes plans for the next fiscal year. Thus, the Budget for 1940 reports accomplishments realized during the fiscal year 1938; a combination of actual and expected results for 1939; and presents forecasts and recommendations for the fiscal year, 1940 beginning July 1, 1939.

In summary, the contents of the 1940 Budget were as follows: I. Budget Message of the President; II. Budget Statements; III. Estimates of Revenues and Receipts; IV. Estimates of Appropriations and Expenditures; V. Estimates of Appropriations in Detail; VI. Annexed Budgets; VII. Informational Tables.

The Annual Report of the Secretary of the Treasury

The report includes a discussion of financial condition and operation including present condition, past accomplishments and forecasts for the future. It also contains administrative reports of the bureaus and divisions of the Treasury Department. Numerous exhibits and tables amplify the narrative.

The main parts of the report are as follows: Summary of the State of the Finances; Administrative Reports of Bureaus and Divisions; Exhibits; and Tables.

Combined Statement of Receipts, Expenditures and Balances

This report is prepared pursuant to Section 15 of the Act of July 31, 1894 which reads as follows:

"It shall be the duty of the Secretary of the Treasury annually to lay before Congress . . . an accurate combined statement of the receipts and expenditures . . . designating the amount of receipts, whenever practicable by ports, districts, and States, and the expenditures, by each separate head of appropriation. (U. S. Code, 1934 Ed., Title 5, Sec. 264.)

The main headings of the Combined Statement are: Introductory Material; Receipts; Expenditures; and Tables.

Digest of Appropriations

The annual digest of appropriations is prepared by the Division of Bookkeeping and Warrants of the Treasury Department. Appropriation acts relating to the particular fiscal year covered by the digest are grouped according to organization units of the Federal Government.

Annual Report of the General Accounting Office

The annual report of the General Accounting Office prior to the report for 1938 contained relatively little financial data but was concerned for the most part with reporting the condition of the work of the Office and making recommendations for changes in legislation and procedure. The 1938 report contained several hundred pages of financial statements. But the report was typewritten, not printed, and is not available for distribution. It contains a total of over 1200 typewritten pages on paper 14″×10″. The contents are as follows:

Foreword

Letter of Transmittal

Chapters

I. The Audit of Public Accounts
   A description in some detail of the audit of public accounts; the forms for accounting, etc.

II. The Accounting System of the Government
   A report of the progress being made in establishing an accounting system for the Federal Government

III. The Settlement of Claims
   A description, in some detail, of the transactions treated and settled as claims by the General Accounting Office and some procedure followed in connection therewith.

IV. Advance Decisions and Preaudit Distinguished
   A brief statement in explanation of the essential difference between advance decisions and preaudit.

V. Financial Statements
   A presentation of financial statements for all agencies of the Government together with a consolidation of certain factors common to all, on which notations pertaining to audit have been made.

VI. Work of the General Accounting Office
   A detailed statement regarding the work of the General Accounting Office, the number of vouchers and accounts audited and settled, the number and class of documents handled, etc.

VII. Legislative Recommendations
   Recommendations for changes in legislation which are believed to be desirable and necessary to improve accounting and to safeguard public funds.

Report of Emergency Funds

The report is prepared pursuant to requirements of the Emergency Relief Appropriation Acts of 1937 and 1938. The report, which covers operations through December 31, 1938 and condition as of that date, is a document of several hundred pages. It was prepared and printed by January 10, 1939. Thus, it represents an outstanding accomplishment in the field of fiscal administration.

Daily Statement of the United States Treasury

The statement regularly contains the following information:

1. Current assets and liabilities
   a. Gold
   b. Silver
   c. General Fund
2. Receipts and expenditures for the particular day covered by the statement
3. Comparative analysis of receipts and expenditures for:
   a. This month
   b. Corresponding period last year
   c. Current fiscal year
   d. Corresponding period previous fiscal year
4. Outstanding federal reserve notes, Federal Reserve Bank Notes, and National Bank Notes
5. Transactions affecting the circulation of Federal Reserve Notes, Federal Bank Notes, and National Bank Notes.

On the tenth of each month the daily statement carries receipts and expenditures, and a statement of account for funds under the Social Security, Railroad Retirement, and Railroad Unemployment Insurance Acts.

On the fifteenth of each month receipts and expenditures applicable to relief are reported.

On the last day of each month a preliminary statement of the public debt is presented. A combined statement of the assets and liabilities of government corporations and agencies is also included.

Statement of the Public Debt

This report is issued once a month as of the close of the month to which applicable. It contains the following statements:

(1) Statement of the Public Debt of the United States as of the close of the month.
(2) Detailof Outstanding Interest-Bearing Issues.
(3) Contingent Liabilities of the United States.
(4) Detail of Contingent Liabilities.
(5) Securities Owned by the United States.
(6) Memorandum of Amount Due the United States from the Central Branch Union Pacific Railroad.

Cost Accounting

For administrative activities, the analysis of expenditures by organization units (or particular lines of work, usually referred to as projects) and objects of expenditures extends throughout the Government service. The classification of expenditures according to objects was prescribed by Bulletin No. 1 of the General Accounting Office. In summary the classification is as follows:

Objects of Expenditures

Current Expenses

01. Personal Services
02. Supplies and Materials
03. Subsistence and Support of Persons (Service)
04. Subsistence and Care of Animals and Storage and Care of Vehicles (Service)
05. Communication Service
06. Travel Expenses
07. Transportation of Things (Service)
08. Printing, Engraving, Lithographing, Binding, Photographing, and Typewriting (Services)
09. Advertising and Publication of Notices (Service)
10. Furnishing of Heat, Light, Power, Water, and Electricity (Service)
11. Rents
12. Repairs and Alterations
13. Special and Miscellaneous (Current) Expenses
14. Maintenance and Operation, Shore Stations —Navy
15. Maintenance and Operation, Fleet—Navy
16. Miscellaneous Operating Charges—Navy

Fixed Charges

20. Interest
21. Pensions, Retirement Salaries, Annuities, World War Allowances, and Insurance Losses
22. Grants, Subsidies, and Contributions

Acquisition of Property

30. Equipment (includes livestock)
31. Land and Interests in Land
32. Structures Parts and Nonstructural Improvements to Land (Includes Fixed Equipment)
33. Stores Purchased for Resale
34. Reserves Stores on Hand—Navy

Payment of Debt

40. Public-Debt Redemptions and Purchases

Capital Outlays for Rights and Obligations

50. Investments (Includes Working Capital Funds)
51. Treaty Obligations
52. Repayments of Deposits
53. Refunds, Awards, and Indemnities

For manufacturing, construction work, and farming, the Government has developed cost-accounting methods. Some organizations have developed operation and maintenance cost systems. Among the agencies which meet modern requirements along these lines are: the Bureau of Reclamation, the Bureau of Prisons, the

Rural Electrification Administration, the Forest Service, and the Tennessee Valley Authority.

COMMENTS BY

Paul D. Banning

The topic, "Federal Accountkeeping," if it were to be dealt with in its entirety, would involve consideration of the whole of the vast fiscal system of the United States Government. It would include the accounts in the Treasury, those in the General Accounting Office, and those throughout all departments and establishments. In addition, the discussion would involve the accounts of corporations financed with capital paid in by the United States. The ramifications of governmental accounting are so far-reaching that it has seemed desirable here to consider only one of the various groups of accounts: departmental accounting systems. I will undertake to discuss only the more common objectives, ordinarily sought in the operation of such systems. Needless to say, the views expressed here are merely my own; they do not reflect any pronouncement of official policy; nor do they have any official sanction.

Under the Budget and Accounting Act of 1921, the General Accounting Office is authorized to prescribe the forms, systems and procedures for administrative appropriation and fund accounts in the several departments and establishments and for the administrative examination of fiscal officers' accounts and claims against the United States. As tersely stated in its latest annual report, the General Accounting Office prescribes systems of administrative appropriation and fund accounts which comprise appropriation controls with subordinate budgetary accounts, administrative allotment accounts, receipt accounts, encumbrance accounts against which the approved vouchers and disbursements are recorded, and other accounts to reflect asset acquisitions and operating costs.

Preliminary to a discussion of the more specific objectives in Federal accountkeeping, it might not be amiss to mention a few recognized principles applicable to the accounts of governmental organizations. Among the more important of these principles are: the accounts should be operated on a double-entry basis, with appropriate classifications for assets, liabilities, revenues and expenditures; the accounts should be maintained by groups which are self-balancing for each appropriation or fund; accounts should be maintained for receivables and payables; effect should be given to accruals of revenues and expenditures; obligations should be encumbered against available funds at the time commitments are incurred; accounts should be maintained for expendable and nonexpendable property, such accounts being subject to verification and correction by physical inventories; depreciation of working assets should be recognized and provision made either in the general accounts or property records, in order that such expense shall be included in the cost of any services sold or commodities produced; the system should provide adequate internal controls, through distribution of functional responsibility among employees, and the installation of checks and balances in the accounting procedure, to insure accuracy in the accounts, and to protect against possibilities of fraud or peculation by employees; the accounting records should be correlated through centralized control, so as to facilitate the presentation of financial information on a current basis; and finally, the system should be operated at a cost commensurate with the ends attained through the maintenance of the accounts.

Aside from the foregoing more or less self-obvious axioms, the design of appro-

priation accounts involves four, and possibly more, specific considerations. These are:

1. Form and content of records used
2. Production of information for appropriation estimates
3. Budgetary control and recordation of transactions
4. Preparation of financial statements

For many years the systems of appropriation and fund accounts in the different Federal agencies varied widely, each system conforming largely to the ideas of the fiscal officer in charge of the activity. In the year the Budget and Accounting Act was passed, 1921, the Institute of Government Research, an organization associated with the Brookings Institute of Washington, D. C., published "The Principles of Governmental Accounting and Reporting." Later, the General Accounting Office, in 1926, assisted by representatives of the Institute, promulgated G.A.O. Circular No. 27, setting forth an outline of an illustrated system of appropriation accounts. Since that time increasing interest has been evinced in the subject, not only in connection with the accounting systems in the Federal government but also in connection with those in the States and municipal governments. With the expansion of governmental functions, both national and local, a demand has developed for improved technique in the preparation of classifications of accounts and in the introduction of labor saving devices in keeping such accounts. In many agencies, a little careful planning in the design of accounting records has produced beneficial effects in reducing manual effort, in providing more effective internal controls, and in producing periodic statements.

The many agencies administering Federal activities have different problems to meet. The nature of the activity, the form of organization, and the degree of fiscal control desired, give rise to important differences in accounting systems. In many respects, however, there is considerable similarity in practices throughout the government. Common to nearly all Federal accounting units are three classes of records: first, the general ledger, which ordinarily contains the summary account classifications; second, the allotment records, which are coördinated with the budgetary accounts in the general ledger; third, miscellaneous records, analyzing or supporting one or more of the remaining summary accounts in the general ledger. Perhaps the most noticeable similarity in the accounting systems of the different departments, is the extent of the use of standard forms for handling government transactions. Among the more important of these, are forms for the general-ledger sheets, appropriation-ledger sheets, allotment-ledger sheets, requisitions for disbursing funds, schedules of disbursements and collections, disbursing officers' account current, pay rolls, voucher forms for expenses, expense distribution ledgers, etc. In addition to the direct accounting forms, there is a long list of collateral documents, including forms for requests for transportation, identification cards, affidavits, formal receipts, bills of lading, abstracts of agreement relating to advertising and awards, etc. Most of us will agree that a system of well-planned forms can be made the accounting vehicle for carrying forward financial transactions with sureness, dispatch and safety to their ultimate goal in the accounts.

In the Federal government, the system of accounts for appropriated activities should either produce directly, or as a by-product, statistics for appropriation estimates. The annual budget of the United States is a comprehensive document, containing detailed information on all Federal departments and establishments. The

activities of the departments are grouped according to bureaus or lesser offices for which specific appropriations are made. The estimate for each appropriation includes a tabulation composed of three columns, showing: (1) actual expenditures (obligation basis) for the latest completed fiscal year, (2) budgeted expenditures for the current year, and (3) estimated requirements for the ensuing year. Through this arrangement, the Bureau of the Budget and the Congress may compare trends in the cost of operating the agency, upward or downward, over a three-year period.

The cost for each of the three years is further analyzed according to objects of expenditures (i.e., salaries, supplies and materials, travel, transportation, printing and binding, equipment, and other purposes), following a list prescribed by the General Accounting Office. While the printed Classification of Objects of Expenditure contains some thirty or more major classifications, with anywhere from ten to a hundred subclassifications under each heading, usually the objects of expenditures reported by any particular agency will comprise less than a dozen different classifications. To make analytical information of this nature available, accounts for expenditure must be established providing for well-defined classifications. In the Budget, the distribution by objective classification is only part of the analysis required for expenditures. The annual estimate for personal services (usually the most important item in an appropriation for salaries and expenses) must be redistributed to show by salary classification grades (i.e., ranges of pay), and thereunder by types of positions, showing for each type the number of employees and average salary.

In preparing the budget, this latter analysis relating to salaries constitutes a time-consuming element in most Federal agencies. For this reason in the design of an accounting system, thought should be given to producing salary data at economical cost. In a large measure the peak load work in preparing departmental estimates can be avoided by the maintenance of records currently accumulating payments of compensation by types of positions of employees. The job is one that can be handled manually, by conventional bookkeeping machines, or by electrical accounting machines using punch cards, according to the needs of the respective office.

After an appropriation is made, the next matter for consideration is the budgetary control of the amount. Virtually every department or bureau employs a system of allotting funds, which constitutes ear-marking or reserving money for specified purposes. Allotments are made according to organization units, time periods, and objects of expenditure, and sometimes functional activities or projects within an office. The first three bases are the ones more commonly employed in the typical department.

Since Congress ordinarily makes appropriations to major organization units (i.e., bureaus or offices), the funds so provided must usually be redistributed through internal action to subordinate organization units, such as divisions, sections, subsections, and on down the line. Since an appropriation is normally made to cover expenses for a fiscal year, control must be established for regulating the time of expenditure to assure availability of funds throughout the year. The Bureau of the Budget requires a statement at the beginning of the year, apportioning the anticipated obligations on a monthly basis, with justification for any proposed amounts exceeding the monthly average for the year. By this means, it exercises considerable control over the rate of expenditures. This is especially true in rela-

tion to such activities as work relief, construction projects, loans, and emergency measures. On the other hand, the old line activities do not permit much regulation of expenditures as to time, because of the constant factors pertaining to cost of personal services and fixed charges. In addition to making allotments by organization units and periods of time, further divisions may be made according to objects of expenditure, thereby limiting the use of funds to specified purposes, such as personal services, travel, equipment, supplies and materials, rents, etc. Sometimes a limited objective basis is used, a common practice being to make allotments for (1) personal services, (2) travel and transportation, and (3) all other objects.

The system of allotments depends to a considerable degree on the measure of control the head of the agency wishes to retain, so that it is not uncommon to find wide variations between agencies in their procedure for allotting. As the progression moves from general control to specific control, the more likelihood there is, up to a certain point, of producing increased analytical information for administrative control. A system of allotment may be over-done, and require too much refinement in specification of objectives. A large number of objective allotment accounts frequently tends to lessen flexibility in the immediate administration of affairs, and sometimes unnecessarily ties up funds needed for a program. Suffice it to say that the number of allotments should be sufficient, and only sufficient, to cover the points on which external control is desired.

Until an allotment has been made, the administrative officer may take only limited action in prosecuting a program. He must stop short of incurring obligations until he receives appropriate authority. After an allotment is received, the officer in charge of the activity must see that the expenditures do not exceed the amount of available funds. Many departments encumber accounts as anticipated commitments are incurred, an action which often takes place long before the incurment of the actual obligation. It is a common practice, for example, to enter against the related allotment accounts, the annual salaries of permanent employees at the beginning of the year, to ascertain at the outset conditions relating to availability of funds for personal services. Similar action is taken in encumbering rental of quarters and other contractual services on which the amounts to be expended are definitely known at the beginning of the year. In accounting for items such as purchases of supplies and the performance of travel, a different procedure is followed, the general practice being to encumber the related allotments when the purchase, requisition (or contract) is made, or the travel authorization is issued. Some objection has been raised to encumbering salaries and contractual services for a full year, on the ground that the charges so made do not represent matured or accrued obligations, and any statement prepared from accounts kept on this basis presents a misleading picture. In my opinion, the situation which has given rise to this criticism can be remedied by maintaining summary analytical accounts for allotments, showing commitments and free working balances, thereby leaving the encumbrance account for the recording of incurred obligations.

Payment of expenses is made by Federal Disbursing Officers, upon presentation of vouchers or pay rolls certified by the responsible administrative officer. To cover these expenditures, the administrative agency draws a requisition for funds to be placed to the credit of the disbursing officer. When approved, the transaction is consummated through the issuance of an accountable warrant down by the Treasury Department, and the countersigning

of the same by the General Accounting Office, authorizing an advance of money to be placed to the credit of the disbursing officer. Unless otherwise specified by law, the accounts of disbursing officers relating to any particular department are submitted monthly for administrative examination by that department. The account and supporting documents are then transmitted to the General Accounting Office where a post-audit is made and settlement effected in accordance with the provision of the Budget and Accounting Act.

So far the discussion has related mostly to budgetary accounts. There are several other types of accounts which play an important part in systems of Federal accountkeeping. In a paper of this nature, the discussion may well be limited to the more common accounts. Much time would be consumed if all asset, liability, revenue, and expenditure accounts were even briefly treated. From a practical standpoint, very little more can be done than to mention the more common accounts. In the asset group there are cash available for withdrawal from the Treasury, cash in the hands of Disbursing Officers, special deposits, accounts receivable, loans, investments, fixed property, equipment, stores, and work in process; and in the liability group there are accounts payable, trust obligations, general fund receipts, unallotted appropriations, unencumbered allotments, unliquidated encumbrances, and surplus.

The processing of transactions in the accounts should crystallize in the production of financial reports as an aid in the management, and such information should be available regularly at periodic intervals. The form of the statement desired will necessarily have an important bearing on the classification of accounts and the manner in which they are maintained. It has been my observation that rather divergent views are held as to the form and content of governmental statements, just as the same is true in commercial statements. In some cases the material is presented in great detail, in others merely in summary form. Likely no two administrators would entirely agree on the exact form to be used or the detail to be reported.

In commercial practice there invariably come to mind two types of reports: the statement of resources and liabilities reflecting financial position, and the statement of profit and loss revealing financial operations. Both types of statements have a somewhat similar application to the finances of the Government. Federal accountants are not all agreed on the application of the first type of statement. Many of them hold there is little real need for other than a cash balance sheet, insisting that management is concerned only with those assets susceptible of being funded. Certainly, it may be that the administrative officer is not concerned with ratios of capital assets to current assets, or of current assets to current liabilities, or similar comparison (corporations excepted). On the other hand a balance sheet may be made useful in various ways. In the extensive operations of Federal agencies, many of them entering new fields of activity, the administrative head is interested in available cash, receivables, inventory of supplies, value of equipment, outlays for construction, outstanding loans, investments, and obligations due or accrued.

The statement of operations finds more extensive use in departments, since it serves as a periodic summarization of the course of the program. The chief fiscal officer should have available timely information on working funds. He should know the unallotted balance in the appropriation, from which he may make further authorizations for activities; and he should know the unencumbered balance in the

respective allotment accounts, so as to appraise accomplishments and estimate future requirements. To the fiscal officer of a department it is highly essential that he shall have a comprehensively planned budget at the beginning of the year, and thereafter that he shall receive information at frequent intervals. In an organization of any size, it is impossible for one person to superintend all details; the fiscal officer must, therefore, determine in large measure the frequency of reports, the form of statements, and the amount of information he desires. Financial statements of this nature include:

1. Summary statement of appropriations showing allotments by activities.
2. Tabular statements according to allotments, showing unencumbered allotments, unliquidated encumbrances, and disbursements.
3. Analytical statement of expenditures by type of work, objective classification, geographical location, or other desired distribution.
4. Statement of assets, liabilities, reserves and surplus (in such detail and at such times as may be desirable).
5. Miscellaneous statement showing results of operations of trust funds, or special activities.

I have undertaken to outline briefly several objectives in administrative appropriation accountkeeping. As aptly stated by the Commissioner of Accounts and Deposits, "The truth about the accounting system of the Government is that it is not nearly so bad as a great many people believe it to be, nor quite so good as people long in the service consider it to be." The science of accounting is not static in the Government. In many departments noteworthy improvements have been made during the past decade. With recognition of certain deficiencies, accompanied by a desire to improve conditions, still greater gains can be realized in the next decade.

Among the more important problems faced are: (1) the attainment of greater uniformity in appropriation and fund accounts to facilitate the processing of transactions; (2) development of instructions and reference works on classifications of accounts, together with the dissemination of information on approved accounting terminology; (3) clarification of responsibility of certifying officers, accounting officers and disbursing officers (probably requires legislation); (4) development of mechanical aids in processing the enormous volume of work required of the Government agencies; (5) extension of budget control operations, both in the departments and the Bureau of the Budget; and (6) authorization for a centralized accounting agency in the government to maintain summary appropriation accounting records, and to compile consolidated financial reports on government activities.

Likely most of these improvements will come gradually as the result of the recognition of a need for more effective practices by fiscal officers, and also as the result of the exchange of information by such officers with organizations interested in the development of accounting.

THE REORGANIZATION OF FEDERAL ACCOUNTING

Harvey C. Mansfield

It is the purpose of this paper to discuss some of the outstanding problems of organization and procedure in the conduct of the accounting functions of the national government above the departmental level—that is to say, of central accounting and control as distinguished from the fiscal administration of individual operating agencies. The theme of this paper is the development of improved practices, and while few citizens are interested in forms of government as such, abstracted from the results they tend to foster, significant progress toward essential improvements in practice in this field is inextricably bound up with changes in the machinery of central financial control. Present practices are the logical result of present organization. The starting point is, then, an analysis of that system.

It may be useful to state at the outset that the problems to be discussed here do not involve the Constitution. That document, and the implications that have been variously derived from it, provides a convenient arsenal of argumentative weapons, to be sure. Moreover, it is probably true that one feature of the present law, the protection from removal accorded the Comptroller General during his fifteen-year term, is unconstitutional in the academic sense that if it could be brought before the Supreme Court, the Court would have to eat more of its past words in order to sustain the provision than to invalidate it. However, the facts of politics supply whatever defect of constitutional power there is involved: no President has ventured, or seems likely to try, to test the provision in the only way it can be tested, by making a removal. Further encroachments upon executive prerogatives can scarcely pass over a veto, and on the other hand measures that are thought seriously to endanger the constitutional position of Congress in the premises will not reach the President for signature. It may be confidently predicted, therefore, that the Constitution will look with benign tolerance on any arrangement of financial administration that is within the realm of practical discussion.

The problem is one of expediency. What is needed is the adaptation of existing machinery to serve better the established ends of government and the needs of the democratically responsible authorities in it, and to get the necessary work done at the minimum overhead cost consistent with the preservation of the legitimate interests of the parties involved—reckoning as overhead costs both the direct outlay for central supervision and records and the indirect costs of procedures that unnecessarily impede the efficient performance of operating services. In this undertaking we may draw upon the general body of experience in public and private financial administration, recognizing the special circumstances that surround the organization and operations of the federal government, but not attaching undue weight to vested bureaucratic interests as such. If one general principle may be stated for guidance, it is that in an age when administration is the flesh and blood, and often the brain, of democratic government, fiscal controls should aim at liberating the effective energies of the operating agencies.

I

The present system of financial controls

may be characterized as one based on an administrative separation of powers in which most of the constituent elements operate subject to the supervision of both the President and Congress, while one, strategically placed, goes its way largely beyond the reach of either. This situation is a result in part of a failure to think through the consequences of legislation before it was passed, in part the pathological state of hostility subsisting between the President and the House of Representatives immediately after the World War, and in part the individual bent of the first Comptroller General, J. R. McCarl. In combination, these influences converted a system of internal checks and balances within the executive branch, dating in substance from 1789 and operating in somewhat primitive fashion but without undue dissatisfaction under the simpler conditions of prewar administration, into a system grotesquely inappropriate to present needs. Admittedly, the time was ripe for accounting changes in 1921, when governmental activities were stabilized at about four times their prewar dimensions; but the changes made then were ill-advised at the time, and by reason of their rigidity have become progressively less suitable during the past decade. In the name of a laudable purpose, the securing of an independent audit, a system was instituted that not only impedes operations and prevents the accomplishment of the primary purposes of central accounting, but also fails to provide the reassurance of an impartial external appraisal of the accuracy of such reports. What purports to be an independent audit is actually an independent control, competing with other more democratically responsible authorities for influence over the conduct of administration; a control exercised through a cumbersome mechanism and guided by criteria that are nearly, if not quite, irrelevant to significant judgments upon administrative performance. The standards of that control may be summed up as regularity in the production of paper work in strict conformity with instructions devised to supply the Comptroller General, in his own office, with a complete documentary vindication of the legality of every expenditure, as he interprets legality. No good is obtained, nor could conceivably be obtained under the prevailingly high standards of personal honesty in the Federal service, sufficient to offset the hampering consequences of this form of administrative myopia.

The legal basis for the present accounting structure is to be found chiefly in two statutes and two Executive Orders. The Dockery Act of 1894, authorizes the Treasury (through the Office of the Commissioner of Accounts and Deposits) "under the direction of the Secretary," to keep "all accounts of receipts and expenditures of public moneys except those relating to the postal revenues and expenditures,"—on paper a legal monopoly on central accounting; and it directs the disbursing officers of the Government to submit to the Auditors (now the General Accounting Office) regular accounts of their advances, disbursements and outstanding balances, classified according to the appropriations on which they are entitled to draw. This provision was passed at a time when the problem of enforcing standards of fidelity and promptness in the rendition of these accounts was a vexing one. The Dockery Act also purported to give the Comptroller of the Treasury power to prescribe administrative methods in the several departments, but departmental resistance made this nugatory in practice; in fact, the primary operating units were bureaus, and accounts covering an area as wide as a whole department were of a very primitive character.

The Budget and Accounting Act of 1921 was mainly important in the eyes of Con-

gress and the public because it installed an executive budget system. Although the budget features of the Act lie largely outside the scope of this paper, some observations may be noted in passing. First, the Budget Bureau has very properly avoided any central accounting of its own but has relied on Treasury figures and close cooperation with Treasury officials. Second, the somewhat disappointing failure of the Bureau since 1921 to develop its potentialities beyond the routine preparation of estimates has been chiefly due to a policy of self-imposed malnutrition—an attempt, as it were, to set an example of economy by going on a hunger strike. The recent reorganization order transferring it to the Executive Office of the President and providing for the expansion of its research, investigating and planning functions gives promise of enlarged usefulness and more enlightened activity from that quarter in the near future. Third, the very existence of the budget system, with the necessity it imposes upon the departments of justifying their programs before administrative officials as well as before Congressional committes, has been a major factor in the stimulation of progress in administrative accounting in the departments and other operating establishments. In fact, the most notable improvements in Federal housekeeping methods since the World War are probably to be found in the development of overhead management in some of the larger agencies—conspicuously in the Department of Agriculture and the Tennessee Valley Authority—and in this development administrative accounting has played a leading role. Fourth, if and when an executive budget that places a responsibility on the President for the revenue program equal to that he now bears for expenditures should move into the realm of practical discussion, then it is not unlikely that the requisite adjustments in the accounting structure and other administrative relationships might prove too difficult to be accommodated within the terms of the Budget and Accounting Act.

Our present concern, however, is with the less publicized provisions of that Act which established the General Accounting Office by transferring and consolidating under an independent Comptroller General the powers, functions and staffs of the previous Comptroller and the six Auditors of the Treasury, together with one significant addition. The term and tenure that the Comptroller General enjoys are by now generally known: appointed by the President with the consent of the Senate, he is virtually irremovable for fifteen years unless by compulsory retirement at the age of seventy. He is ineligible for a second let alone a third term; but fifteen years is a long time. The functions of the General Accounting Office he heads (which spends currently over $9,000,000 a year, chiefly for the salaries of nearly 5000 employees) are still widely misunderstood. They urgently need elucidation.

These functions may be summarized as follows: (1) the "settlement" of accounts and claims for and against the government and the certification of balances due, which "shall be final and conclusive on the executive branch"; (2) the rendering of advance opinions, upon departmental requests, on the legality of proposed expenditures; (3) the countersignature of warrants evidencing the legality of deposits into and withdrawals from the Treasury and the approval of departmental requisitions for advances to disbursing officers; (4) the prescription of forms and methods of administrative accounting in the departments; (5) although without authority of law, the maintenance of a set of central controlling accounts separate from and in practice not reconcilable with those maintained in the Treasury; and (6) the duty of investigating and making annual and special reports to Congress, with a

correlative right of access to departmental records. There are certain other minor functions requiring no special mention, although if space permitted it would be interesting to dwell on the curious combination of historical accidents whereby the General Accounting Office has assumed the responsibility for performing most of the administrative accounting of the Post Office Department; which in turn is important among the reasons why postal accounting has lagged so far behind progress in some other departments.

The functions listed above are not uniformly applicable throughout the government. They are virtually ineffective as to most receipts, including all the important categories of revenue. As to expenditures, certain entire agencies are exempt from them, and parts of a number of others are also. Certain classes of expenditures are exempt in agencies not otherwise outside the system. Over the remainder of the field the degree of control varies with the language of the statutes and appropriation acts governing each object of expenditure. The operation of these controls calls for some further explanation.

II

1. The "settlement" of accounts and claims is the traditional core of General Accounting Office authority, being the principal duty of the old Comptroller and Auditors. It consists in the examination and determination of the facts and the law surrounding each financial transaction for the purpose of ascertaining the balance properly owing to or from individuals in account with the Federal government. In the legal and accounting theory of the General Accounting Office it makes no difference who these individuals are, or whether payments on their accounts have already been made; if it is concluded that there is no legal authority for a payment, and none has yet been made, the prerequisite approval for making it is withheld, while if the payment has been made, credit for it is disallowed and its return is demanded. In the practice of administration, however, and from the standpoint of the development of central accounting, these distinctions are crucial.

According to the terminology usually employed, the "claims" thus settled are those of private parties—government employees, contractors and others—who are denied what they think is their due by the operating agency they have been dealing with: and offsetting claims of the government against them. Evidently, this is a function normally incidental to the work of all large organizations. There is always room here for argument over the pros and cons of centralization, weighing the advantages of uniform standards and external consideration against the inconveniences, delays and misunderstandings inherent in remote control. The most controversial aspects of this have involved the determination of the General Accounting Office, in the interests of uniform treatment of a highly technical subject matter, to handle in this way all government transportation bills; and the settlement of large construction contracts. Unless a statute specifically vests the final determination of the amounts due in some other officer, claims are settled in the Claims Division of the General Accounting Office and charged to the applicable appropriation; further relief is available only in the Court of Claims or by special act of Congress. Whatever may be thought of the merits of this procedure in particular cases, it raises no serious accounting problems.

The settlement of "accounts" is another matter. These are the periodic (usually monthly) reports of the disbursing officers, covering payments already in the hands of payees and supported by vouchers, certificates, and whatever else may be demanded to prove the regularity of the

payments. They cover approximately 95% of governmental expenditures. The disbursing officers who render them have only an official, not a personal, interest in the payments, since they are not themselves the payees as is the case with claimants who submit their individual claims. They are authorized and required so long as their funds are not overdrawn, to disburse on the presentation of vouchers, payrolls, etc., signed by properly accredited certifying officers in the departments, and they have ordinarily no means of verifying these independently. Nevertheless, the General Accounting Office procedure operates on the fiction that advances to disbursing officers are personal debts of theirs and that when payments they have already made are disapproved and credit in the accounts is accordingly disallowed or temporarily suspended, these amounts are recoverable as personal debts. The accounting system, in other words, holds the disbursing officers as insurers of the legality of their payments, although they are no longer such in law and cannot be in administrative practice. In fact, suspensions and disallowances are cleared by the submission of additional evidence and explanations, by putting the payments on another theory (as by charging them to another appropriation), by recoupment from the payees, or by Congressional relief legislation. Recovery from the disbursing officers themselves or their bonded sureties is almost unknown, except in rare instances of personal defalcation.

The settlement of accounts is thus an external control on the legality of expenditures, not on their amount. The General Accounting Office does not and cannot "save" the Government anything, since the departments are entitled to spend up to the limit of their appropriations, and payments stopped or recovered will be spent for something else. In practice this commonly means simply that the money will be spent according to the department's second or third or fourth (and probably more expensive) choice among the available alternative methods of getting its work done, instead of its first.

The settlement of accounts rests on an external examination of the vouchers and documents supporting payments reported, and this is what defenders of the present system mean when they speak of an independent audit. But it has little in common with that phrase as commercially understood. It does not entail any recourse whatever to departmental accounts, nor any examination of the internal safeguards afforded by departmental procedures, nor any field investigations (apart from some detective work that is a separate function) to get behind the paper showings, nor any periodic review of operating results or comparisons with budgetary estimates that would enable a comprehensive and intelligent judgment to be formed. Finally, in view of the extent to which the Comptroller General is involved at other points in the determination of administrative policies, it is not independent, as that term is commercially used.

It is, however, a potent means of control, since the settlements carry administrative finality: they are "final and conclusive on the executive branch." They may on rare occasions be set aside by court action at the instance of private parties, though the grounds of appeal are so limited that for practical purposes the possibility of judicial review may be disregarded; and it would not be desirable in this field to have it otherwise. They may be reversed by Congress but the only regular opportunity for this is by the addition of suitable language to the annual appropriation acts, an uncertain and time-consuming remedy. It would be highly desirable to provide a more accessible and reliable channel to this end. For the most part, however, as matters now stand, the Comp-

troller General's settlements must be lived with, whether embraced or endured. From this conclusion, which may be verified by observation of administrators in action, several important consequences follow.

For one thing, the attitude of the General Accounting Office is infected with legalism. Having no avowed criteria of action other than the enforcement of the law, the instinct of institutional self-preservation leads it to split verbal hairs and multiply the points upon which proof is required. The point at issue then becomes, not whether a given tankful of gasoline was bought and used for a purpose within the intendment of Congress, but whether the duplicate receipt required of the service station vendor by GAO regulations was duly signed; or whether the car that used the gas was registered in a government employee's own name and not his wife's. Of such stuff are disallowances made. Again, under the guise of enforcing the law, unwarranted interpretations may be read into it, and the Comptroller General's judgments on facts and policies substituted for those of operating officials, even to the point of frustration of the Congressional intent.

Two other tendencies may be noted. One is the continual pressure of administrators concerned with operating results to get statutory exemption from the system, either by securing finality for their findings, as in the case of AAA benefit payments, or in the more thoroughgoing form of immunity from the requirement of rendering accounts at all, as in the case of the Home Loan Banks and the Inland Waterways Corporation. The argument is often too cogent to be denied; it was a chief factor in the formation of many government-owned corporations. But since audit and control are but aspects of a single process, the result is to throw baby and bath out the window together. Moreover, a sense of discrimination is not the least of the ills generated by piecemeal exemptions.

2. The second tendency appears where there are no exemptions, and brings us to the second of the Office's functions, the rendering of advance decisions. If control through settlement of accounts is inescapable and the Comptroller General's views will prevail in the end, then either prudence or timidity may suggest the wisdom of learning the worst as early as possible. Advance decisions were authorized by the Dockery Act to enable doubtful questions of law affecting proposed payments to be resolved before commitments were made. Since 1921, however, the number and scope of the questions submitted has increased to such a degree as to amount in many cases to the submission of administrative programs for approval. Further in the same direction was the introduction of a preaudit procedure, whereby individual vouchers could be routed to the Office for approval before payment. Promises of expedited handling were offered as an inducement to the wide adoption of this device, but at present it is applied to less than 5% of the total number of vouchers, and a much smaller percentage of the total amount of payments. It seems unnecessary to dwell on the incompatibility of these procedures with the role of an independent auditor. They do illustrate, however, the tendency of an effective control to move forward its fulcrum of leverage so as to bring the whole range of administrative action more fully within its scope.

3. The Comptroller General's functions of countersigning warrants and approving requisitions for advances are survivals from an earlier era when problems of fidelity in the handling of public moneys loomed larger. Today they are on the whole harmless as well as useless. Appropriation warrants form the legal basis for setting up appropriation accounts from the general fund of the Treasury; settlement

warrants authorize direct payments from these accounts on claims settled in the General Accounting Office; accountable warrants, drawn against departmental requisitions, authorize charges to appropriation accounts which are credited to the personal accounts of disbursing officers, subject to later clearance when their expenditure accounts are received; transfer and adjustment warrants are self-explanatory; covering warrants evidence the deposit of receipts into the general fund. The fact that Comptroller General's countersignature on all these documents attests the legality of the transactions in question is less important at present than that it brings to his office various posting media that are useful in enabling him to build his own set of central accounts. Comptroller General McCarl attempted to convert this essentially ministerial task into a dangerous discretionary control of funds at their source in connection with the approval of WPA projects in 1935, and by an outrageous usurpation he succeeded temporarily in bending the TVA to his will early in 1936; but this last aberration at least is unlikely to be repeated.

4. The Comptroller General's power to prescribe departmental accounting forms and methods was originally designed to secure uniformity and stimulate progress in that field; it appears now to be defended as essential to the integrity of an independent audit. The latter claim is without foundation; it is on the contrary essential to the independence of an audit that the auditor be free to criticize the manner in which accounts are kept. If the exercise of the power has contributed to the manifest improvements in departmental practice, that have occurred since 1921, it seems likely that they have been brought about rather after the fashion in which the presence of irritant substances induces oysters to secrete pearls. When the General Accounting Office, after a decade of merely sporadic effort, began to take an active interest in this field, the task was at first confined to its Office of Investigations, a detective unit wholly unfitted for the work. More recently, the services of qualified accountants have been brought into play, but every major change in the prescribed forms has had the primary object of facilitating the Comptroller General's control of expenditures, and as a means to this end, the development of central controlling accounts in his office. The continued existence of his power over departmental procedures is today the principal stumbling block in the way of establishing a really satisfactory central accounting system.

5. The reason for the present impasse here is the inevitable competition of rival agencies dealing with the same subject matter, and in view of the ineptitude of present statutes it is probable that the pull of institutional interests is great enough to absolve any individual of blame for the unfortunate result. The Budget and Accounting Act transferred to the General Accounting Office the previous Treasury functions of keeping the personal ledgers of disbursing officers and of settling their accounts; at the same time it left otherwise untouched the Treasury's mandate under the Dockery Act to keep "all accounts of receipts and expenditures." The value of central accounts for the control of expenditures is obvious, and their indispensability in the arrangement of current financing and the preparation of the Secretary's Annual Report to Congress is equally so. The Comptroller General's central accounts are cumbersome because, apart from the initial warrants, they must be assembled from the reports of disbursing officers, rather than from the departmental accounts directly; they are incomplete because of the exemptions from his control; and they are delayed because they wait on materials that are not submitted

until after at least a month following the transactions they record. The Treasury's central accounts, based on the records of the Treasurer's office and telegraphic reports from disbursing officers, as well as the warrant record, are up-to-date in point of time, and comprehensive in scope, but they do not dovetail with departmental accounts over which the Treasury has no authority. Only new legislation can cut this Gordian knot.

6. The most dismal aspect of the experience under the Budget and Accounting Act is the utter failure of the General Accounting Office to develop its investigating and reporting functions. Nothing remotely resembling an audit report on the operations either of the Treasury or of the departments has ever emerged. For this failure two related reasons may be assigned: the Comptroller General's marked preference for his role as comptroller, and the absence in Congress of any suitable machinery for handling his reports if they had deserved consideration.

The unsuitability of the Budget and Accounting Act has been heightened by two innovations introduced by Executive Orders. The first, in 1933, centralized all civilian disbursing (except postal) in the Treasury, and transferred the liability for improper payments from the disbursing officers to departmental certifying officers. This removed the last logical reason for using the monthly accounts of the former, instead of accounts of organization units, as the primary basis for controlling expenditures. But although the change would make accountability parallel administrative responsibility, it would also entail a complete change in the bookkeeping and filing methods, as well as in the habits of thought, of the General Accounting Office; and it has not been made.

The second innovation was the designation of the Treasury in 1935 to handle the administrative accounting for all emergency relief appropriations. Starting from scriatch, but with adequate technical and financial resources, the Commissioner of Accounts and Deposits has achieved what can only be called a miracle of governmental accounting and reporting. Although it would not be wise to burden the Treasury with a general responsibility for the performance of administrative accounting, the experiment carries some instructive lessons. First, it demonstrated the possibility of publishing complete financial reports of federal agencies that are both prompt and illuminating—a demonstration repeated on quite a different model in the last two annual statements of the TVA. Second, by a system of internal preaudit and review, the Treasury has virtually eliminated disallowances from its emergency relief accounts, leaving practically nothing to be shown for the subsequent General Accounting Office settlement. This should suggest some far-reaching doubts about the value received for the present efforts devoted to an item-by-item postaudit form of settlement. Third, if there is any fire behind the smoke about WPA expenditures, mountains of paper work provide no guarantee of finding it; and the substitution of a field audit should be considered—which returns us to our original premise that the primary reliance must be upon the personnel and methods of the line agencies.

III

The reorganization bills before Congress in 1938 contained sweeping proposals designed to meet the kind of difficulties that have been noticed here: the divorce of control and audit, vesting the one in an executive agency and the other in an independent office safeguarded as the Comptroller General now is; and the establishment of a Congressional Joint Committee on Public Accounts. The program would have given

administrative finality to the determinations of an executive comptroller separated from the operating establishments but not beyond the reach of democratic responsibility; cleared the way for unified central accounting and reporting; required a field postaudit reaching administrative accounts as well as expenditure transactions; and provided an orderly and accessible channel for securing Congressional review of disputes. The form of these proposals differed in the two houses, but each chamber considered on its merits and voted the version introduced there before hysteria killed the program as a whole.

The Reorganization Act of 1939 avoided all controversial topics, but the simultaneous appointment of a new Comptroller General, amiably disposed if inexpert in the field, seemed not to foreclose the possibility of renewed attention to the problem in Congress. That prospect dims with the lapse of time. A campaign year is not the most auspicious occasion for legislative innovation. The very process by which Comptroller General Brown learns his way in his new surroundings is also a process of inculcation with a fixed point of view, for the same division chiefs are there to teach him who implemented Comptroller General McCarl's policies. It is bootless to peer beyond 1940.

It is not inconceivable that within the terms of the 1939 Act some improvements can be worked out in accounting procedures and the routing of documents between the Treasury and the departments that will facilitate the progress of central accounting. But the Reorganization Act specifically excepts from its scope "the whole or any part" of the General Accounting Office and its functions, and this precludes touching the roots of the difficulties. Much more could be accomplished by a joint invocation of the Reorganization Act and the Comptroller General's power over administrative accounting methods at once, if a coöperative agreement on objectives could be reached. But aside from the inherent obstacles to this the unfortunate accident that a few days ago incapacitated Comptroller General Brown must at least for the time stand in the way of the adoption of new policies.

We face a period of stalemate on fundamentals despite rapid technical progress in the refinement of operating procedures. From the larger point of view of national welfare, and wholly apart from individual judgments on the merits or adequacy of the 1938 proposals, stalemate is peculiarly dangerous at this time. Two distinct factors are at work that must soon underline more emphatically the difficulties. Deficit financing of government has proceeded for an extended period, and its end is not in sight. There is in sight a marked shift in public sentiment which promises to make its continuance an acute political issue. However that issue is decided, the leadership in handling it must rest with the executive. Whether deficits are to be newly and more strongly defended, or whether they are to be curbed, effective executive action will require a far more efficient and smoothly working central accounting mechanism than we now have to provide the information that is the beginning of wisdom.

A quite different threat looms in the prospect of a wartime economy. Neutrality is not shielding the nation from immensely increased expenditures for the defense services. In the face of overwhelming demands for speedy action, Congress will surely relax further the expenditure controls in the General Accounting Office on this program, as it has already begun to do. But unless the system is changed, exemption from control is exemption from audit. It would be courting political disaster to risk the repetition of the last war's record of defense expenditures without the safeguards of an independent public audit.

THE RISE OF THE PROFESSION OF ACCOUNTANCY IN ENGLAND

MARY E. MURPHY

THE *City:* These words, meaningless to many foreigners, convey to Englishmen both at home and abroad a picture of London's financial district. They call up memories of Threadneedle and Lombard Streets, the Bank of England, the Royal Exchange, Lloyds, and the Stock Exchange. Nestled in the midst of this complete concentration of most of the Empire's business and in fact much of that of the rest of the world is Great Swann Alley which for generations has housed that honorable body, the Institute of Chartered Accountants in England and Wales.[1] Any day, after ten o'clock and up until teatime, black-suited accountants can be seen bending over their ledgers, laboriously adding endless columns of figures, and putting down their sums. H. V. Morton in his "Nights of London" has described the Chartered Accountant as possessing "eyes like gimlets and a mouth like a line drawn across a balance sheet. Many, however, become human by marriage with good women, they grow roses, have children, and in time look human. This out of business hours, of course."

Down the Thames on the Victoria Embankment stands the delightful Incorporated Accountants' Hall built in 1895 as a residence on the western boundary of the Temple by William Waldorf Astor, later the first Viscount Astor.[2] In addition to these two outstanding professional organizations there are twelve smaller societies in England today, their inception in the main being due to the Revenue Act of 1903 which limited income-tax accounting strictly to members of incorporated societies.[3]

The profession of accountancy holds a place of honor in England, ranking with the ministry, medicine and the law. Its traditions have been built up over years of practice and they display a general air of austerity and conservatism. In fact, Lord Stamp has said: "I do not know anybody who is so tied to conventions as the accountant and when a convention is once established it needs dynamite to move him." The decisions handed down by the learned judges in cases involving accounting considerations are constantly referring to the profession as distinguished, honora-

[1] The Institute of Chartered Accountants in England and Wales was incorporated by Royal Charter on May 11, 1880. In 1939 its total membership was 13,068, composed of 2,316 fellows in practice, 198 fellows not in practice, 2,878 associates in practice, 6,424 associates not in practice, 30 fellows not in England or Wales, 1,222 associates not in England or Wales.

[2] Permanent home and head office of the Society of Incorporated Accountants and Auditors. The Yearbook states the 1939 membership as follows: fellows 1,528; associates 5,978; honorary members 3; total 7,509.

[3] The Report on Registration of Accountants, Cmd. 3645, pp. 4–5 supplies the following data:

Date of Incorporation	*Name*	*Membership*
1891	Corporation of Accountants, Ltd.	1,927
1901	Institute of Municipal Treasurers and Accountants (Incorporated)	642
1903	Institution of Certified Public Accountants Ltd.	175
1905	London Association of Accountants, Ltd.	2,900
1905	Central Association of Accountants, Ltd.	739
1919	Institute of Cost and Works Accountants, Ltd.	796
1923	Institute of Poor Law Accountants, Ltd.	409
1923	British Association of Accountants and Auditors, Ltd.	333
1927	Society of Statisticians and Accountants, Ltd.	300
1927	Professional Accountants' Alliance, Ltd.	158
1928	Faculty of Auditors, Ltd.	200
1929	Institute of Company Accountants, Ltd.	600

ble, and essential to the commercial well-being of the nation.[4]

The English accountant should be viewed in relation to the activities of his profession, and in relation to the economic and social aspects of his country. To a marked degree his effectiveness is conditioned by existent legal and financial philosophies. It is frequently difficult for an observer of the English scene to reconcile the two conflicting thoughts that find expression there: the desire for business to be accorded as full a measure of laissez-faire as possible, and the theory that business activity should be somewhat regulated. The passage of the various Companies Acts which combat the most blatant business sins are a concrete expression of the latter view. Underlying the first view is the adherent desire on the part of companies in a whole to foster secrecy in regard to business statistics. The most progressive members of the accounting profession make unremitting efforts to combat the withholding of vital information from share-holders but they receive little aid from the English legal structure which, in the main, emphasizes the policy of non-interference in business affairs unless there is positive proof that they are being conducted illegally. The freedom from restraint accorded to English business activities has greatly affected the endeavors of accountants as it is frequently impossible for them to require publication of data which the law holds unessential for shareholders' use. This is a perplexing state of affairs in a country where audits are compulsory and where there is a qualified accountant for every 1,850 persons.

The following basic ideas should be recognized in examining the English profession of accountancy:

1. Business is largely based upon individualism and the development of personal initiative.
2. The main threads of English life are closely woven into definite patterns and these constitute the traditions of the race.
3. The legal structure is considered to outline the territory within which the individual pursues his activities and upon which he erects his own codes of ethics. His personal codes are utilized from day to day and operate quite apart from the legal requirements pertaining to particular situations. Certain things are "not done" because they are not "cricket."

Although the profession of accountancy in England is inextricably bound up with the various Companies Acts it is of interest to note that practicing accountants actually preceded their enactment.[5] Both the Companies Act 1862, recognizing the general principle of limited liability, and the Bankruptcy Act 1869, giving official recognition to the accountant, greatly promoted the profession. The development of English accountancy should be viewed in relation to the spread of limited liability companies and to the acts which were passed from time to time to bring these intangible beings under the control of the state.[6]

English economists and accountants constantly refer in their writings to the separation of ownership from control of company property and the necessity for an accounting to be rendered to the real owners of limited liability companies yet English law appears to be behind social and economic change as it does not, to any important degree, reflect this separation

[4] Note, for example, the decisions of Mr. Justice Wright.

[5] In 1800, according to Sir Nicholas Waterhouse, there were only about 100 accountants in practice. In 1823 Charles Lamb in his "South-Sea House" thus immortalized the accountant: "The shade of some dead accountant, with visionary pen in ear, would flit by me, stiff as in life."

Myers, John, "A Century of Professional Accountancy," *Accountant*, Feb. 24, 1934, pp. 267–272, states that the Post Office Annual Directory for 1830 listed accountants, with the name of firms and individuals described as accountants, agents and patents; accountants and general agents; accountants and translators; accountants and referees.

[6] Jordan, H. W., *Sixty Years of Company Registration*, London, Jordan and Sons, Ltd., is an excellent review of the various Companies Acts.

and its implications.[7] Compulsory registration of companies took place after the passage of the Companies Act 1862 but it was not until the enactment of the Companies Act 1900 that registered companies were compelled to appoint auditors and not until the Companies Act 1929 was there a legal requirement that companies should keep proper books of account. For years the tenets of the profession have been evolving and although they are today in a state of flux English accountants must ascertain that the accounts they examine are accurate and that they show a true and correct view of the state of affairs of the business under audit.[8] Writers in the field of accountancy do not pose hard and fast rules, neither do the judges trying cases involving alleged negligence of practitioners hand down invariable decisions. Emphasis is at all times placed upon the rendering of professional services to the business world and to the public. Such a statement implies the employment of expert knowledge on the part of practitioners; the development of research in the field of accountancy and in fields touching upon it; the recognition of and adherence to legal and moral codes of ethics; the emphasis upon public service rather than upon personal remuneration. Sir John Simon has formulated the following tests which reveal a profession:

1. It is based on preliminary study, training, and perhaps examination.
2. Profits made from its pursuit do not depend upon the command of great quantities of capital.
3. It is a pursuit which is not followed solely as a means to a livelihood.
4. It is subject to codes of professional honor including the strict observance of confidences.

When these tests are applied to the profession of accountancy it can be readily seen that it meets them in every particular. It is the constant desire of the English societies that professional standards of practice may be elevated and they endeavor to achieve this end by the development of written and unwritten codes of ethics and by discipline of members. At all times the profession fights against inertia; it strives to prevent its members withdrawing too much from the world, allowing their standards to become outmoded and their terminology comprehensible only to themselves. The English profession of accountancy strives to inculcate professional ideals in the mind and heart of each of its practitioners—it urges each to pursue the loftiest ideals in order that practice may advance and keep step with major social and economic changes. English accountants play an important part in politics and as directors of public companies. Prime Minister Chamberlain once likened the position of the English accountant to that of the family solicitor and he pointed out that he is increasingly being appointed to directorships, as an arbitrator in trade disputes and on trade boards, as an assessor on high governmental committees, and as an adviser to the government on matters of great import. That the practitioner is selected for this distinguished and con-

[7] Pigou, A. C., *The Economics of Welfare*, London, Macmillan and Co., 1932, p. 151: "There is clearly room for improvement in the matter of business publicity." Marshall, Alfred, *Principles of Economics*, London, Macmillan and Co., 1930, pp. 301–304: "There is every reason to hope that the progress of trade morality will continue, aided in the future by the dimunition of trade secrecy and by increased publicity in every form." Cole, G. D. H., *Modern Theories and Forms of Industrial Organization*, London, Victor Gollancz, Ltd., 1932, pp. 17–32. Smith, H. A. M., "The Public and Company Accounts," *Nineteenth Century*, Sept., 1931, pp. 337–344: "Secrecy is a fetish of the average English business man." Hill, H. L. H., *Presidential Address of Chartered Accountants*, May 7, 1932: "In my opinion the dangers arising from publishing more informative accounts have been overstated and the legitimate claims of shareholders have not received adequate recognition." Garnsey, Sir Gilbert, *Holding Companies and Their Published Accounts*, London, Gee and Co., 1936, p. 120: "Perhaps the real opposition to any but the most essential changes in the form of published accounts often comes from boards of directors who are not imbued with the desire to give their shareholders as much information as possible."

[8] De Paula, F. R. M., *Principles of Auditing*, London, Sir Isaac Pitman and Sons, 1934, Chapter One.

fidential work indicates that he stands in high repute both with his government and the public, and that he takes pride in his profession, waging war against lowering of personal or group standards, constantly striving for greater professional attainments.

REGISTRATION OF ACCOUNTANTS

A Committee headed by Viscount Goschen was appointed by the Board of Trade in 1930 to investigate the subject of registration of accountants. Bills had been introduced in Parliament in the years 1891 and 1911 dealing with registration but neither of them, because of opposition from all sides, became law. When the Committee Report was rendered there were 17 societies in existence in England with a membership of 26,500. The profession of accountancy tried but failed to draw up a definition of accounting which would include all the duties performed by the accountant, excluding such services as were rendered by other professions. In consideration of the subject of registration of English accountants it is necessary to remember that although the Companies Act 1900 made it compulsory for companies to appoint auditors there is no definition of their qualifications even in the Companies Act 1929.[9] While it is true that certain persons such as directors and officers of a company, cannot become auditors, nevertheless individuals with no accounting knowledge or experience can under the law be appointed auditors of public companies.[10] Neither is there any statutory definition of the scope of the audit of the balance sheet or of what comprises a properly prepared balance sheet.[11] These matters are left to the consideration of the parties concerned with the audit, namely, the company and the auditor.

In spite of lack of registration of English accountants the investigatory committee decided that the business world did not suffer pecuniary loss. The auditors for friendly and building societies were found to be appointed to a panel by the Treasury

[9] Sec. 132 (1) of the Companies Act 1929 (19 & 20 Geo. 5. Ch. 23): 1. Every company shall at each annual general meeting appoint an auditor or auditors to hold office until the next annual general meeting. 2. If an appointment of auditors is not made at an annual general meeting, the Board of Trade may, on application of any member of the company, appoint an auditor of the company for the current year. 3. A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate the person to the office of auditor has been given by a member to the company not less than 14 days before the annual general meeting, and the company shall send a copy of such notice to the retiring auditor, and shall give notice thereof to the members, either by advertisement or in any other mode allowed by the articles, not less than 7 days before the annual general meeting. . . . 4. Subject as hereinafter provided, the first auditor of the company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until that meeting: provided that a. the company may at a general meeting of which notice has been served on the auditors in the same manner as on members of the company remove any such auditors and appoint in their place any other persons being persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than 7 days before the date of the meeting, and b. if the directors fail to exercise their powers under this subsection, the company in general meeting may appoint the first auditors and thereupon the said powers of the directors shall cease.

[10] Sec. 133 (1) None of the following persons shall be qualified for appointment as auditor of a company: a. a director or officer of the company; b. except where the company is a private company, a person who is a partner of or in the employment of an officer of the company; c. a body corporate.

[11] Sec. 134 (1) The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and the report shall state: a. whether or not they have obtained all the information and explanations they have required; and b. whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company. 2. Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of auditors. 3. The auditors of a company shall be entitled to attend any general meeting of the company at which any accounts which have been examined or reported on by them are to be laid before the company and to make any statement or explanation they desire with respect to the accounts.

and it was shown that to impose upon private companies the necessity of hiring a registered accountant would mean additional expense to them. It was pointed out that any firm employing an accountant could easily investigate his reputation in the community before entering into a contract with him; that registration would tend to standardize accounting procedures and reduce the morale of the members of the profession; that if accountants should ever in the future clamor for registration or for any other legal protection the public would recognize that the profession was insecure; that if they fulfill their position in society economic forces will maintain them to a greater degree than any legal distinction or protective measure (such as registration) that could be devised. William Cash (Chartered) in his testimony pointed out that registration would have to consider solicitors who frequently prepare and render accounts, bankers who advertise they will assist with income-tax returns, surveyors and estate agents who keep and render estate accounts, accountants to public companies who perform audit duties, and honorary auditors of hospitals and charities. Lord Plender (Chartered) submitted data showing that in 1929 of 5,518 companies listed in the *Stock Exchange Intelligence* 4,971 were audited by Chartered Accountants and that while the Institute favored registration in 1911 it no longer did so because of its improved status. Henry Morgan speaking for the Incorporated Accountants held that while registration would not benefit his society it would eventually elevate the ethics of the entire profession by eliminating unsatisfactory practitioners. The investigatory committee finally held that registration was neither necessary nor advisable in England at that time.[12]

The contemporary feeling in England within the profession of accountancy is that it is far better for it to evolve its standards than that they be laid down by statute as this tends to routinize procedure and to hold practice to a minimum legal requirement. In the final analysis, it is the profession itself which must assume the responsibility for improving the practices of and the discipline of its members. The official organ of the Institute, the *Accountant*, publishes results of trials heard by its Council against members. Section 20 of the Royal Charter of that organization deals with suspension and expulsion of members, and By-Law 107 gives the Council power to publish notice of action in selected newspapers and journals. The discipline of members by their societies is somewhat reduced in effectiveness because those expelled may continue to pursue the same practices which led to their suspension or expulsion as they are not prohibited from engaging in accounting practice. The maintenance of the English accounting profession in the opinion of the public lies within the power of its members. Their personal reputations are the means by which society recognizes and measures the true-value of the profession itself.

DEFINITIONS OF AUDITING

Since it is essential for English accounting practice to remain in the state of plasticity its problems must constantly be regarded with an open mind. The auditing text recognized as classic in England is the one by Lawrence R. Dicksee. By examining its editions, from the first which appeared in 1892 to the fifteenth and latest edited by Stanley W. Rowland, one may trace the development of auditing in this country. An audit in the latest edition is defined as an "examination of accounting records undertaken with a view to establishing whether they correctly and com-

[12] *Report of Departmental Committee Appointed by Board of Trade on Registration of Accountants*, Viscount Goschen, Chairman, Cmd. 3645, p. 20.

pletely reflect the transactions to which they purport to relate."[13] Another English authority defines an audit as "such an investigation into a set of books and into the documentary evidence from which such books have been written up as will enable an auditor to make a report upon the balance sheet or other statements which have been extracted therefrom to those to whom he is appointed to report."[14] As shareholders are not accorded the privilege of inspecting companies' books it is essential that a regular and systematic audit be made of company accounts by qualified auditors so that all parties at interest, including the public, may receive protection.

In England directors are responsible for the accounts of their companies and it is the auditor's task to take the balance sheet prepared by them and to audit it.[15] He must not change it but he is at liberty to comment upon it in his report. Under existing conditions two main classifications of audits are evident: those of companies where the auditor's duties are defined by statute; those of private individuals and firms where his duties are not defined by statute but are based upon a contract existing between his client and himself. English audits may be complete or partial. The exact extent of the auditor's work is left to his judgment as a result of the theory that he is a skilled individual in his profession. He must not restrict himself solely to the task of "ascertaining that the balance sheet or other accounts which he certifies are in accordance with entries in the books or are a correct record of transactions."[16] He may rely on test checks of the books and need not examine all the transactions, and he may rely on certificates and statements of persons in authority in the company under audit. He must use reasonable skill and if his suspicions are aroused he must exercise greater diligence than would otherwise be the case. These are the general principles underlying the auditor's work in England. He is considered to be legally responsible only if he could have discovered the incorrectness of the books through a reasonable examination of them. Undoubtedly the English accountant could offer valuable advice to his client but it is generally considered that it is not within his province to do this unless he is specifically requested. He must satisfy himself that the balance sheet exhibits a true and correct view of the affairs of the company as shown by the books and according to the explanations and information he has received. Generally speaking it is his duty to convey information rather than to arouse inquiry as shown by London and General Bank 1895 2 Ch 673. He must at all times realize that accounts may be erroneous and if the facts are combined in a misleading way they may be the basis of a suit as demonstrated in Rex v. Kylsant, Ct. of Crim. App. 1931. The decided reluctance of most English accountants to work for an amendment of the Companies Act 1929 regarding the provisions for the profit-and-loss account and holding company accounts indicates that they feel if requirements as to certain functions of auditors are stated in law the companies under audit will only allow the minimum requirements to be met which would tend to reduce the standards held by the most

[13] Rowland, S. W., *Auditing*, London, Gee and Co., 1933, p. 1.

[14] Taylor, E. M. and Perry, C. E., *Principles of Auditing*, London, Textbooks, Ltd., 1935, p. 1.

[15] Sec. 129 (1) Every balance sheet of a company shall be signed on behalf of the board by two of the directors of the company . . . and the auditors' report shall be attached to the balance sheet, and the report shall be read before the company in general meeting, and shall be open to inspection by any member. (3) If any copy of a balance sheet is issued, circulated, or published without having a copy of the auditors' report attached thereto, the company, and every director, manager, secretary, or other officer of the company who is knowingly a party to the default shall on conviction be liable to a fine not exceeding fifty pounds.

[16] Cutforth, A. E., *Audits*, London, Gee and Co., 1931, pp. 1–4.

outstanding practitioners. Flexibility and greater strength to combat business "crimes" is achieved by the profession by leaving unwritten many of the professional and personal codes underlying its members' work.

The English accountant's moral if not his legal responsibility tends to expand as his usefulness to society moves into different and enlarging channels. He is a powerful agent in combating business secrecy and the withholding of information from shareholders on the pretext that it will aid competitors. His task is increasingly difficult as companies continue to become more involved in organization, to operate on a narrower margin of profit and to desire to withhold certain information from their competitors. The accountant's role is important as he must furnish sufficient accounting data for the use of the managers and owners of a business, and at the same time satisfy the desire and demand for data on the part of the public and the Government.

GENERAL PURPOSES AND SCOPE OF THE AUDIT

Under the Companies Act 1929 a company is required for the first time to keep proper accounts.[17] The literature in the field of English accountancy contains many references to the question of amendment of this Act so that it may provide definite instructions as to the profit-and-loss account, as to the methods of accounting and statements to be utilized by holding companies and their subsidiaries. An investigatory committee held against amendment of the present Act believing that shareholders should be allowed to formulate the requirements of their company's accounts. Its report stated that "it is often forgotten that it may be in the best interest of the shareholders that the accounts should be in a certain form and we consider that undue interference by legislature in the internal affairs of companies is to be avoided, even if some risk of hardship in individual cases is involved."[18] As shareholders usually form a more or less apathetic body the amount of influence they can actually exert on company accounts is probably small. It is true that in England they attend meetings in large numbers and with regularity and exercise their legal right to ask questions of company chairmen. They can exercise their right to remove the auditor if they comply with company law regarding this procedure. The act that the directors appoint the first auditor, he retaining his position unless changed by the shareholders which is a relatively infrequent procedure, does not lessen the moral as well as legal statue and protection afforded the auditor by ths fact that he is deemed responsible to the shareholders.

The English accountant besides performing audits, in addition devises systems of books and internal checks, advises on the form and mode of account presentation, and assists in rationalizing industry.[19] One leading member of the profession has suggested that the auditor should bring his influence to bear on the improvement in the law and practice of accounting in order that accounts may not only be true but informative as well with no misleading impressions conveyed to

[17] Sec. 122 (1) Every company shall cause to be kept proper books of account with respect to a. all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place; b. all sales and purchases of goods by the company; c. the assets and liabilities of the company. 2. The books of account shall be kept at the registered office of the company or at such other place as the directors think fit and shall at all times be open to inspection by the directors. This section also covers penalties for directors not taking reasonable steps to secure compliance by the company with the requirements of this section.

[18] *Report of Company Law Amendment Committee*, Wilfred Greene, Chairman, 1926, Cmd. 2657, p. 74.

[19] Howitt, H. G., "Present-day Demands on Auditors and the Effect of the Companies Bill Thereon," *Accountant*, Jan. 28, 1928, pp. 127–131.

their readers as to the company's financial position or operating results.[20] Under contemporary conditions the English auditor endeavors to ascertain that the statements to be submitted to shareholders are not only in accordance with the books of account but he forms an opinion as to whether they truly and correctly state the facts of the business. In addition, he tries to form an opinion as to whether the management of the company under audit has dealt fairly with the shareholders in their maintenance of accounts and preparation of statements.

GENERAL PRINCIPLES OF AUDITORS' LEGAL AND MORAL RESPONSIBILITY

The legal duties of the English auditor are covered by Section 134 of the Companies Act 1929. His moral duties go far beyond these legal duties and arise from custom and ethical standards which the profession and he maintain. The auditor must not only know and obey the law as it exists but he should go beyond it into the realm of moral duties which he himself conceives to be essential, based on the facts concerning the particular audit under consideration. Moral practice should blaze the way for legal dicta and it is thought best in England that practice should be outlined by the profession before it is finally codified in law. The English auditor is required to exercise reasonable skill and he is not responsible for fraud which could not have been discovered by the exercise of the usual diligence. For these terms, reasonable skill and diligence, it is difficult to supply definitions; each case must be settled on its merits. The English Companies Act makes no attempt to define the exact duties of the auditor as circumstances vary greatly; English courts hearing cases measure them against average modern practice and they do not impose upon the auditor arduous obligations which would tend to make his position intolerable.[21] Lord Plender speaking before the International Congress of Accountants in 1926 contrasted legal decisions with the accountants' acceptance of responsibility by pointing out that the legal standard of accounting is high but that it did not rest solely upon adherence of accountants to legal principles but that it was based upon their acceptance of a much wider moral duty and responsibility. He pointed out, also, that the mere observance of legal requirements by accountants would lead to evasion of responsibility upon technical grounds and to acceptance of too narrow a view of personal obligation. Practitioners must, therefore, know the law and follow it, and accept moral responsibilities emanating from their professional activities.[22] The auditor should not be expected to do the work which belongs to the directors. It has been frequently suggested that English directors should be made civilly liable for their acts and that the part of the auditor's engagement which is concerned with the detection of defalcations should be set apart in the auditing contract and dealt with by the directors themselves through their system of internal check. At the present time the English accountant is responsible for every item on the balance sheet and the examination of this statement is thought to include a verification of the profit and-loss account as well although this is not stated by law to be the case. The English profession should decide whether it is in favor of full disclosure being given in profit-and-loss accounts and what princi-

[20] Morgan, Henry, "The Accountant's Responsibility in Relation to the Balance Sheet and Profit and Loss Account from the British Point of View," *Accountant*, Sept. 9, 1933, pp. 425–435.

[21] Smails, R. H., *Auditing*, London, Sir Isaac Pitman and Sons, Ltd., pp. 11–26.

[22] Plender, Lord, "Accountants' Certificates in Connection with Accountants' Responsibility," *Accountant*, July 10, 1926, pp. 47–58.

ples it conceives to underlie these statements.

A review of the more important legal cases involving auditors leads to the following conclusions regarding the English audit:[23]

1. An accountant must honestly satisfy himself that the accounts show a true and correct view of the financial position of the company under audit.
2. He must examine the books and satisfy himself that they are correct.
3. It is not part of his duty to take stock.
4. He is entitled to rely upon the opinion of experts where special knowledge is required.
5. He is not required to be suspicious.
6. It is not part of his duty to give advice.
7. If he is not satisfied upon any material point he must report clearly to shareholder or partners.
8. He must verify the existence of assets so far as is reasonably possible.
9. In case of a company he must see that the memorandum and the articles are carried out.
10. If he is negligent he may be liable in damages.
11. What is reasonable care depends on the circumstances but the general standard of the profession must be considered also.
12. In a private firm the auditor should have the scope of the audit in writing.
13. He is not liable for tracking out ingenious and carefully laid schemes of fraud.
14. If he wilfully certifies accounts knowing them to be false he is criminally liable.
15. He incurs a risk by not disclosing secret reserves.
16. He is responsible for the profit-and-loss account and must see that it does give a fair view of the earnings of the period and that the profit-and-loss accounts are prepared on the same basis each year.

RECENT PROFESSIONAL DEVELOPMENTS

The Royal Mail Case is considered to have had a beneficial effect upon business methods, and upon English accounting and auditing techniques because after its decision more information has generally been disclosed by directors of companies, and auditors' opinions are more readily accepted by them. No English auditor can place his dependence upon the law alone as this will prescribe the minimal; it is his duty to envisage and bring about the adoption of a higher standard based upon his acceptance of ethical obligation and fiduciary responsibility. Of course, there are some clients upon whom no moral persuasion can be evoked; they will desire only that the law be met. If the directors conform to the legal requirements there can be no objection raised by the English auditor but he tries at all times for the revelation of the maximum of data consistent with good practice and the requirements of the particular company. A close perusal of the Companies Act 1929 shows that it does not specifically require that the auditor state whether or not the view of the company's affairs presented is correct. One critic has scored the Act in this connection indicating that as long as the balance sheet is drawn up to the best of the accountant's information he is under no express duty to obtain correct information or to get explanations.[24] The opinion generally held by English accountants is that proper accounting and auditing procedures may be arrived at more easily by the use of auditor persuasion than by the development of an inflexible legal structure defining the duties and responsibilities of auditors. The Institute has always opposed legal regulation of auditors' duties and responsibilities.[25] Its members appear to be divided into two groups: those

[23] Summarized from De Paula, F. R. M., *Principles of Auditing*, London, Pitman and Sons, 1936, pp. 232–237.

[24] Samuel, Horace S., *Shareholders' Money*, London, Sir Isaac Pitman and Sons, Ltd., 1933, pp. 240–270.

[25] This view is emphasized in the words of H. L. H. Hill's Presidential Address before the Institute in May 1932: "I am thankful to believe that the time will never come when legislation can be so definite and comprehensive that auditors will be reduced to mere automata, to obey audit programs laid down by statute. We must take the lead so that if and when further legislation is enacted there may be at the time an established practice that will assist those who frame our laws."

favoring reform and those who believe in the policy of auditor persuasion of directors rather than in outright modification of existing statutes. The incorporated Accountants are generally in favor of English Company Law reform particularly with reference to the profit-and-loss and holding company accounts. English accountants must constantly fight against the tendency upon the parts of company directors and even themselves to regard the legal minimum requirements as the desired maximum in relation to form and content of accounts and statements. Such a tendency, if not combated with all the power of the individual practitioner and his society, would eventually lead to stifling advancement in reportorial methods and the regimentation of individual initiative into procedures and principles of accounting prescribed by law rather than by the practitioner.

TREASURY STOCK: A SOURCE OF PROFIT OR LOSS?

CALVIN H. RANKIN

ACCOUNTANTS have often marveled at the misunderstanding of generally accepted accounting procedure and concepts, which the courts have in the past exhibited. Many decisions not only show misunderstanding but indicate a failure on the part of the courts to attempt to ascertain the meaning of accounting terminology which their decisions employ. It is unfortunate therefore to find a court in a recent tax decision[1] turning for guidance to "correct accounting" as set forth in theory and practice only to find lack of agreement on the part of accountants as to theory and even greater disparity between theory and practice. It is only fair to state that the court found a similar lack of agreement on the question in the court decisions it examined. The case involved that much discussed, but never settled, question of treasury stock. Perhaps when the last word is said, if ever, the decision will be similar to that of the court, "There is room for debate—(it) is reasonably susceptible of two constructions."

The problems of accounting arising out of treasury shares are important and of practical significance. For example, in 1933 a well known tobacco company[2] reports a profit of $5,000,000 on the disposal of its own shares. Is this sound accounting? Its other earnings for the year were $16,000,000 including dividends paid to itself on these treasury shares. Is this proper accounting procedure? Prior to its sale, the cost of acquiring the shares, $18,000,000, was carried as an asset under the heading "Investments in Non-Competitive Companies, etc.," the exact nature being disclosed by a footnote. Is this presentation justifiable?

The above case does not stand alone. The practical and theoretical importance of the problems is further illustrated by the fact that out of 500 balance sheets examined by Sanders, Hatfield and Moore[3] for the four year period, 1933 to 1937, over 300 contained items of reacquired shares. These authors devote a considerable

[1] *Reynolds Tobacco Co.* v. *Helvering*, Fed. 97 (2) 302 (1938).

[2] R. J. Reynolds Tobacco Co. Financial Statement, 1933.

[3] *A Statement of Accounting Principles*, American Institute of Accountants, 1938.

amount of attention to treasury shares and set forth the treatment of reacquired shares on the balance sheet as one of its twenty-five general accounting principles.[4] The Tentative Statement of Accounting Principles Affecting Corporate Reports specifically mentions treasury shares in four of the twenty propositions.[5]

Since corporations and shares in corporations are creatures of the law, a study of the accounting problems of treasury shares should begin with the ascertainment of the legal nature of treasury shares. This would be a formidable task if we had only the conflicting court decisions relating to treasury shares to rely upon. Fortunately, the American Law Institute, to whose studies the courts are now constantly referring for guidance, has devoted its attention to the restatement of corporation law, following the weight of authority unless it appeared unsuited to present social or business conditions, in which case principles deemed more advisable have been formulated. The work thus far completed is in tentative form[6] but throws helpful light on "Treasury stock."

The *Restatement of the Law*, just referred to, points out that perhaps the greatest source of confusion as to treasury shares was due to the use of the word "stock," to denote what the members of a corporation have, that is an interest in certain aggregate rights and duties arising out of such association. It is more accurate to refer to the members associated in a corporate enterprise as "shareholders" and to use the word "shares" instead of "stock" to denote the units into which the various legal relations of the whole body of shareholders as such is divided. A "stock certificate" would necessarily become a "share certificate," evidencing the existence of one or more shares and the holder thereof.

The use of such terminology would have made it clear that while a transfer of shares from A to B eliminates A and causes B to become a shareholder with a shareholder's rights and duties, the "acquisition of shares" by the corporation cannot create similar rights and duties in the corporation or constitute it a shareholder. "A corporation is never in any useful sense a shareholder with respect to its own shares."[7] And probably the more accurate description would be not "acquisition of shares" but "liquidation of shares."

In the absence of specific statutory prohibition, or an actual reduction of authorized capital in the manner provided by statute, a corporation "purchasing" its shares has acquired nothing more than the power to recreate similar shares.

It is probably true that these shares may be recreated in a slightly different manner and with slightly different legal results from the original creation of the shares. First, there is no pre-emptive right in the voting shareholders if "treasury shares" are recreated and they were acquired by the corporation with such intent. That is, each voting shareholder does not have the right on the creation of voting shares from this source to have offered to him a sufficient number thereof to maintain his proportional voting control in the corporation. Second, it is possible though by no means certain, in the absence of a specific statutory provision, that the acquiring shareholder will not be held liable to creditors for any discount if he purchases the shares at less than par. Third, it is possible that prior approval of the shareholders will not be necessary to recreate such shares, even though it might be necessary in order to create shares from the power inherent in "authorized but unissued" shares.

It will be noted that these differences

[4] *A Statement of Accounting Principles*, pp. 89–91, 116.

[5] #12, #15, #16, and #18, ACCOUNTING REVIEW, June, 1936.

[6] *Restatement of the Law of Business Associations.* Tentative Drafts #1, 2 and 3. American Law Institute 1928–1932.

[7] *Ibid.*, Tentative Draft #2, p. 9.

constitute either a removal of formalities to be observed in the creation of shares or a possible elimination of shareholders liability to creditors, in each case a change in purely legal incidents of the creation of shares.

In all other respects "treasury shares" are similar to "authorized but unissued shares"; they may not be voted by the corporation either directly or indirectly; where a vote of a certain percentage of the "capital stock" or "outstanding capital stock" is required by law, treasury shares are to be eliminated from consideration in computing the denominator of the fraction; dividends should not be paid on treasury shares, although that practice is still sufficiently prevalent to provoke a ruling by the Securities and Exchange Commission to the effect that dividends on treasury shares should not be included in income.[8]

It should be observed that the American Law Institute proposes to eliminate preemptive rights in respect to treasury shares only in cases where those shares were acquired under circumstances which reasonably indicate an intention to recreate the shares and where nothing has subsequently occurred to indicate that the intention has been abandoned. It further states:[9] "When a corporation acquires shares, the intent to exercise the power thus acquired to recreate shares of a similar class and number is evidenced by speaking of the shares as if they had not been canceled, but rather still existed and belonged to the corporation; as where the shares are spoken of by the corporation as 'Treasury Shares'." To illustrate, it is further stated that where treasury shares have been carried on the books of a corporation in an account called "Treasury shares," the directors have indicated their intention to recreate shares either at once or at some later period when conditions make it advisable to do so. An examination of the accounting authorities on the question, shows that such an inference is unwarranted since accountants, irrespective of the directors intent to recreate the shares, use such an account in every case where treasury shares are acquired and there has been no formal reduction of stated capital under the law.

One other legal provision which affects the accounting treatment of treasury shares is the general rule of law, reflected in many statutes, that a corporation may not "purchase" its own shares if thereby the net assets are reduced below the amount of stated capital, sometimes referred to as the requirement that treasury shares must be "purchased" out of surplus. Also it follows that surplus, to the extent of such cost, may not be used for dividends or the "purchase" of additional treasury shares.

The foregoing analysis leads to these conclusions. First, accounting statements should reflect the acquisition of treasury shares, the application of surplus for this purpose, and the resulting power to recreate shares. Second, the "purchase of treasury shares" should be treated in the accounting records as a redemption of shares or partial liquidation, and the subsequent "sale of treasury shares" the same as any original issue of shares. There is certainly nothing to justify treating "treasury shares" as an asset, but on the contrary the legal restrictions on "purchases" to the effect that net assets must not be reduced thereby below stated capital, clearly implies that "treasury shares" is not an asset.

How are these conclusions to be applied in accounting procedure for the "purchase" of treasury shares?

Accountants are today in substantial agreement that treasury shares are not to

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[8] *Accounting Series*, Release #5.

[9] *Op. cit.*, Tentative Draft, #1, sec. 17, p. 43, comment a.

be shown as an asset on the balance sheet[10] but as a reduction in shareholders' equities. This treatment conforms to the law.

Some accountants recognize this general rule but still contend that treasury shares may be shown as an asset in particular cases, such as treasury shares acquired for employee bonuses,[11] when the shares are held in a pension, insurance, or sinking fund[12] or even when the shares are held for "sale" on the market by the corporation. Sanders, Hatfield and Moore state "some circumstances seem to require, or at least to justify, its treatment as an asset. Such cases should, nevertheless, be regarded as exceptional."[13] The securities and Exchange Commission has stated that when "treasury stock" is carried as an asset reasons must be also stated.[14] Others have considered these claimed exceptions to the general rule and rejected them as unwarranted.[15]

In the light of the law these rejections seem justified. Treasury shares should be shown at cost as an "unallocated reduction of capital and surplus,"[16] pending their disposition. A parenthetical clause or footnote should state the restriction on the use of surplus because of the "purchase" of such shares.

Some accountants advocate that treasury shares be carried at par or stated value, showing this amount on the balance sheet as a deduction from stated capital.[17] In such a case the restriction on surplus should also be disclosed as previously explained. This treatment is avoided by some accountants on the theory that it gives the impression of a reduction of "stated capital" which under the law may not have taken place.[18] There appears a more serious objection to this method, since treasury shares may not be "purchased" in excess of surplus.

In all cases when treasury shares "purchased" are carried at par or stated value, although the "purchase" price is greater or less than the par or stated value, an offsetting reduction or increase in surplus must be provided. If the *entire* surplus is appropriated to "purchase" shares at less than par or stated value, there will arise an increase in surplus, giving the false appearance of surplus still available for dividends or the further "purchase" of treasury shares. Similarly, if the *entire* surplus is appropriated to the "purchase" of treasury shares at more than par or stated value there will be a corresponding decrease in surplus, giving the erroneous impression that more surplus has been appropriated to this "purchase" than was available at the time and placing a restriction on surplus in excess of the new surplus amount.

Carrying treasury shares on the books at cost avoids this increase or decrease in surplus.

Another plan is sometimes suggested of showing treasury shares at cost as a de-

[10] "A Tentative Statement of Accounting Principles Affecting Corporate Reports," ACCOUNTING REVIEW, June, 1936, 187; Gilman, Stephen, *Accounting Concepts of Profit*, The Ronald Press Company, New York, 1939, p. 163. Securities and Exchange Commission. Instructions Book for Form 10K, Balance Sheet Item #31.

[11] Byerly, F. P., "Formulation of Accounting Principles or Conventions," *Journal of Accountancy*, August, 1937, p. 98. Trouant, D. L., *Financial Audits*, American Institute Publishing Co., New York 1937, p. 55.

[12] See R. J. Reynolds Tobacco Co., Financial Statement, December 31, 1938.

[13] *A Statement of Accounting Principles*, American Institute of Accountants, New York 1938, p. 90.

[14] *Accounting Series*, Release #7, p. 4; Also Instruction Book for Form 10K—Balance Sheet Item #10.

[15] Comments of W. A. Paton in "A Statement of Accounting Principles," *Journal of Accountancy*, March, 1938, p. 206; see also Paton, W. A., *Essentials of Accounting*, The Macmillan Company, New York 1938, p. 684; Watson, Albert J., "Principles Related to Treasury Stock," *Papers on Accounting Principles and Procedure*, The American Institute of Accountants, 1939, p. 31.

[16] ACCOUNTING REVIEW, *op. cit.*, June 1936, p. 190; Graham, W. J., and Katz, W. G., *Accounting in Law Practice*, Callaghan and Company, Chicago, 1938, p. 166.

[17] Apparently this is the treatment advocated by Sanders, Hatfield and Moore. *Op. cit.*, pp. 90, 116.

[18] Bowles, H. G., "Treasury Shares on the Balance Sheet," *Journal of Accountancy*, August, 1934, p. 98.

duction from surplus.[19] This serves the purpose of indicating the restriction of surplus, but does not clearly show the fact that it is the shareholder's equities consisting of both stated capital and surplus, which have been reduced by the "purchase" of shares.

Where treasury shares are acquired by "purchase" the transaction itself may constitute a reduction of stated capital under the law or the corporation may take statutory proceedings for a reduction of stated capital thereafter. Then the restrictions on surplus arising out of the purchase would be removed and the partial liquidation effected by the "purchase" of shares should be transferred from "treasury shares" directly to the shareholders' equity accounts, capital and surplus. Since the "purchase" represents a distribution in redemption of shares, the proper entry should charge the book value of the shares retired pro-rata to the capital and surplus accounts, irrespective of the "purchase" price. If the treasury shares are "purchased" at more or less than book value, the problem is presented of the proper treatment of the difference between the price paid and the book value.

No attempt will be made to discuss the problem as to whether the "purchase" of shares by a corporation on the market at more or less than book value should cause a consideration of whether the indicated book values are inflated or understated on the basis of present values as distinguished from historical costs, and the possibility of a revision of asset book values. It may be that a "purchase" price above or below book value merely indicates the influence of certain financial conditions on security values which do not measure the value of the enterprise as a whole and which should have no effect on the accounting procedure of the corporation.

[19] Marple, Raymond P., "Treasury Stock," *Journal of Accountancy*, April, 1934, p. 257.

Omitting any such considerations, it is clear that if the shares are "purchased" above book value, the average book value of the remaining shares is decreased; if shares are "purchased" below book value the average book value of the remaining shares is increased.

Does this increase or decrease in the book value of the remaining shares constitute a gain or loss to the corporate entity to be reflected in the income statement?

It seems preferable to consider this increase or decrease as an adjustment between the retiring shareholder's and the remaining shareholders' equities, and not as a gain or loss to the corporation within the generally accepted meaning of those terms. It is a transaction similar to the crediting of the premium on preferred shares to capital surplus. This may increase the book value of the common shares but it has never been contended that such an adjustment of equities between shares gives rise to corporate gain or loss.

These transactions are either donations or forfeitures by one class or group of shareholders to another class or group of shareholders. If partner A upon retirement, allows a portion of his capital to be transferred on the books to partners B and C, it cannot be said that the partnership enterprise has realized a gain or suffered a loss. It should make no difference that the proprietorship interest eliminated is that of a shareholder instead of a partner.

Even under the entity concept a gain or loss does not result. This concept considers both shareholders' equities and creditor indebtedness as liabilities. The liquidation of creditor indebtedness at more or less than the amount recorded on the books has always been considered as resulting in loss or gain to the corporation under any concept. Does it not therefore follow under the entity concept that the

liquidation by a corporation of its shareholders' equities at more or less than book value results in loss or gain to the corporation?

The difference in the two cases seems to be this. A loss or gain on the liquidation of creditor indebtedness flows down through surplus and decreases or increases the shareholders' equities, which is the residual and final liability under the entity concept. Legally this final liability cannot be completely liquidated until all other liabilities are satisfied. The liquidation of a shareholder's equity at more or less than book value only affects the residual shareholders' equities, causing readjustment of those residual equities, as between retiring and remaining shareholders. Suppose the prorata "purchase" of shares at less than book value from all the shareholders. It would be absurd to consider that the corporation had profited. It would seem that, only in that highly theoretical case where the sole remaining shareholder's interest is liquidated at less than book value, can it be said that the corporation has realized a gain and that gain would be offset by the fees of lawyers required to determine what to do with it?

The conclusion must be that if the "purchase" price is less than book value, the reference, upon reduction of stated capital and charging prorata all surplus accounts entering into such book value, should not be considered a gain and should be credited to surplus as a donation by the retiring shareholder.[20]

Similarly when the corporation pays the retiring shareholder more than book value, any excess, after such book value is removed from the accounts reflecting it, must be treated as an additional distribution to him by the remaining shareholders and charged to surplus. It should not be considered a loss to the corporation.

[20] See Kester, Roy B., *Principles of Accounting*, Ronald Press Co., New York, 1939, pp. 452, 458.

The Treasury Department now agrees that a partial liquidation never results in taxable income or deductible loss to a corporation.[21]

The "sale" of treasury shares can never result in "gain or loss." The question of "gain or loss" arises solely at the time of "purchase," not at the time of "sale." The account "treasury shares," carried on the books when stated capital has not been reduced as provided by law, represents an unallocated reduction and adjustment of shareholders' equities. If the treasury shares are later disposed of, the entire amount received from the new shareholder, should be recorded as any issue of stock,[22] the par or stated value being credited to "Capital Stock" and the difference, if any, being adjusted through surplus. The "Treasury Shares" account having served its purpose as an unallocated item in suspense may now be closed out in the same manner as discussed for a reduction of capital or the two entries may be combined making any charge or credit to stated capital unnecessary.

The "purchase and sale" of treasury shares, though not resulting in "gain or loss" may cause an adjustment between surplus accounts, depending upon the classifications of surplus which are finally accepted.[23]

These conclusions seem sound from a theoretical standpoint.

Some accountants do not favor a theoretical approach to these problems with "involved explanations" but prefer to consider the "purchase" and "sale" of its own stock

[21] Regulations 101, Article 22(a)-21. While the Treasury Department does not agree that a mere "purchase" of shares is a "partial liquidation," if a statutory reduction of stated capital is effected it would seem clear that a "partial liquidation," under the law, has taken place.

[22] See Paton, W. A., *Essentials of Accounting*, The Macmillan Co., New York 1938, p. 683; also Kester, Roy B., *op. cit.*, p. 459.

[23] "Is it Desirable to Distinguish Between Various Kinds of Surplus?" *Journal of Accountancy*, April, 1938, p. 281.

by a corporation as being similar to the purchase and sale by it of "machinery or shoes."[24]

The present Treasury Department Regulations and some court decisions in tax cases lend support to the practical approach.[25]

It remains to be seen whether practical or theoretical considerations will play the greater part in the final analysis of problems of treasury shares.

[24] See Montgomery, Robert H., "Dealings in Treasury Stock," *Journal of Accountancy*, June, 1938, p. 466.

[25] Regulations 101, Article 22 (2)-16 (Income Tax); Regulations 64, Article 47 (Capital Stock Tax); In First Chrold Corporation v. Commissioner, 97 Feb. (2) 22, reversed 59 Sup. Ct. 427 because the decision was contrary to Treasury Department regulations in force at the time of the transactions, the Circuit Court said: "The answer to the question presented depends upon whether it is made to turn upon a theory or a fact. In theory a corporation cannot own a share in itself. When it purchases shares in itself, it thereby reduces its capital. When it reissues the stock it increases its capital. The transaction is a capital transaction. In fact corporations do buy and sell their own corporate shares, as they buy and sell other forms of property, ignoring, as we have said, the fact that the shares are their own. These are 'as if' transactions. The shares are bought and sold as if they were not the corporation's own shares. The capital of the corporation is not affected and the transactions are not capital transactions. If the subjects of purchase and sale were, as is assumed, not the corporation's own shares, the gain, if any, would be an income gain."

ACCOUNTING RESEARCH: OBJECTIVES AND METHODS

T. H. SANDERS

It is not my purpose to deal at length with the materials or subject matter with which accounting research might concern itself. While some mention will be made of these materials, I am more concerned to develop certain points of view which I think should animate the research worker in accounting.

AXIOMS OF ACCOUNTING RESEARCH

It seems desirable at the outset to consider certain axioms which men engaged in accounting research are often disposed to regard as self-evident, often, it would appear, without being conscious of that fact. The first thing for the accounting research worker to undertake is an examination of his own mind, and the assumptions he is making, expressed or implied. Is he, for example, already accepting as a fact the matter which he sets out to investigate? Is he in the position of saying: "these are the arguments on which my facts are based?" All are agreed that an objective viewpoint is the first necessity for successful research, but it cannot be admitted that this principle is regularly observed in practice.

A common assertion by research workers is that a given generally accepted principle ought to be re-examined, or that indeed all of them ought to be re-examined. This is a proposition which in itself can receive general consent. But it often happens that the statement "that generally accepted principles of accounting should be re-examined" is frequently made by those who already have rather definite ideas for converting those generally accepted principles into something entirely different from what they are, or were ever intended to be. It is difficult to regard activities conducted under those conditions as objective research, or to regard the findings of such activities as valid conclusions after impartial inquiry. In such cases the first things to be re-examined are the assumptions of the person undertaking the research.

Some regard it as axiomatic that principles are generalizations from good practice; others deny this and claim that principles are something primary and basic, which govern practices but are apart from them. Such arguments are always in danger of becoming highly metaphysical and I do not propose to pursue them very far. Philosophers sometimes tell us that all knowledge can be embodied within the small compass of a relatively few principles. The only trouble with such a condensed statement is that it can be understood only by those who prepared it, and there is serious question as to how far even they understand it. For my part I am prepared to derive the principles of accounting from the results of practical experience, and to call those the best principles which best serve the purposes to be accomplished. This does not necessarily mean a very narrow definition of accounting as an applied, practical art; nor is it incompatible with the idea that accountants must from time to time consider their purposes from a viewpoint fundamentally different from those they have become accustomed to accept. Examples of this will be given later in this paper.

Another axiom tacitly accepted by many writers is that accountants as a body are ultra conservative and adverse to change. In certain respects this is true, though probably not more true than of like bodies of men in other professions. But it is not true to the extent that accountants have not regularly and frequently adapted accounting practices to the current and changing requirements of business and the public interests. The extent to which they have in fact done this cannot be apprehended by anyone who starts with the assumption that they are incapable of doing it in any degree. Nor is it true that all progress has been forced upon them unwillingly by influences outside the profession. A considerable number of changes have come about in that way, but these are relatively small compared with the developments evolved within the profession; and there is also the question as to whether all changes are improvements.

An axiom which ought to be in the mind of every research worker, but frequently is not, is that principles themselves conflict in their application. Those who conceive of principles as primary truths deny this, for they say that primary truths cannot conflict. This goes back to the question of what is a principle, but it would be easy to show that a great many conceptions which have been called principles do conflict with each other. It then becomes necessary to determine how far each may be applied, and at what point one principle is superseded by another.

Most accountants have regarded it as an axiom that accounts should in general be stated on a historical cost basis, but this proposition has been violently attacked in recent literature. Perhaps it may be said that this axiom is generally accepted among accountants; it is often questioned by others who regard themselves as competent critics of accountants. This evidently indicates matter for further investigation and research.

Another axiom generally accepted among accountants, but not necessarily elsewhere, is that a balance sheet should balance. Col. Montgomery has lamented the limitations which this imposes upon accountants, and those who are not accountants have criticized it in still more devastating terms. But most accountants are aware that double-entry is something more than a mechanical check on accuracy; it is an instrument which, when fully and properly used, can be made to develop the significant phases of any financial situation. It is not a far-fetched idea that the interests or equities in a group of assets should be stated in amounts equal to the amounts attributed to those assets; any

change in the asset amounts necessarily implies a change in the equities in them. The trouble is that there is too much temptation to be satisfied with a mere accuracy in balancing, without a rigorous examination of the specific contents of the balance sheet. But this is a failure to use the method properly, and not a failure inherent in the method itself.

It would be possible to point to books and articles which tacitly assume that all government regulation of accounting is good in itself. While most of us will agree that in the present condition of affairs some government regulation is desirable and necessary, few will go the length of agreeing that every new increase of regulation is productive of good. One could imagine some very interesting and useful research which had an objective study of that question for its purpose.

Proceeding to a body of writing which emanates largely from outside the accounting profession, it is frequently there regarded as an axiom that the entire scope of the public accounting profession should be enlarged to proportions far beyond what they have ever been. It is asserted that the public interest requires that somebody express an authoritative opinion upon the subject matter of corporate financial statements, to the extent of showing how good the several companies are, and the intrinsic value of various securities. It is easy to acquiesce in a proposition so generally stated, without agreeing that the accountant should undertake all of those functions. Still more it may be agreed that the insistence of these demands will require one of two solutions—either that the accounting profession will accede to the demands, or else that it define its scope and purposes more clearly than ever before, and in terms which will satisfy not merely its own members, but the public at large. I shall not here attempt any answer beyond pointing out once more the vast gulf which lies between stating accounts of past transactions, and embarking upon the future estimates which form the essential basis of security values. But this should not be taken to imply any one definition of the accountant's function.

THE NATURE OF EVIDENCE

It is important for the research worker to train his own mind to consider the purport of evidence, what evidence is required to establish a given proposition, what evidence is admissible for certain purposes, and how to evaluate conflicting evidence. This is another matter which goes beyond the technics of accounting. It is said that the organic chemists are often dissatisfied with the findings of inorganic chemists, feeling that these findings have been reached upon too narrow a basis of evidence. In turn, biologists are impatient with organic chemists for the same reason. Then, medical men condemn biologists in the same terms. All of these sciences represent ever widening viewpoints and each succeeding stage calls for evidence on a new and larger basis. In law, the rules of evidence have been worked out with great care in order to determine what proofs will be adequate to determine the questions at issue. The accountant is beset with the same kinds of problems, and should learn to weigh evidence with the same expert skill.

For example, questions as to the desirability of one accounting practice as compared with another require evidence as to how well the different practices will serve the purposes in mind. Such evidence calls not only for facts as to the working out of the different practices, but also for evaluation of those facts. This latter is the really difficult task, calling for a keen and realistic sense of social values. Thus it very soon runs into men's basic conceptions of what the good society is, or should be. About this most of us have our own

ideas, many of which probably come under the heading of propositions which should be reexamined. Unless we are willing to sit back now and then, and look over our most cherished thoughts very coolly and objectively, we are not entitled to be called true research workers in our field.

PURPOSES OF ACCOUNTING

Any work in accounting research must continually bear in mind the purposes for which accounts are prepared. A broad statement on this subject was included on the first page of Accounting Research Bulletin No. 1:

> The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties.

If it is true that corporation accounting is to be judged by "the results which are produced," and if in turn "these results must be judged from the standpoint of society as a whole," these circumstances must continually be in the mind of the research worker.

The purposes of accounting lie in three main fields of usefulness: (1) to management, (2) to investors, and (3) for government purposes. It would be of interest and importance if some research work could establish the relative importance of these three objectives. All of them must be served, and it may be granted that all of them must be served as well as possible. But in the nature of things there is some danger that the second purpose, information to investors, may be emphasized to the detriment of other purposes, especially the needs and purposes of management. The comprehensive question with regard to investors is "what information shall be published for their benefit?" And since it is published information, it naturally attracts a great deal more attention than the uses to which accounting is put by management, since these are conducted in the privacy of their own offices. From this point of view we can appreciate the precise significance of the words of Chairman Frank of the S. E. C.: "The *ultimately* controlling fact affecting the investor in such companies is nothing more or less than that reasonably prospective net earning power." The italics are those of Mr. Frank; for present purposes I should like to italicize the words "affecting the investor." On this basis the chairman's statement, as well as most of his conclusions from it, can be accepted without question. But what would be "the ultimately controlling fact affecting the management of such companies?" It is not unrelated to the other answer, for while investors are engaged in trying to estimate the "reasonable prospective net earning power," the management is using the information in striving to make those net earnings. If the facts could be known it would almost certainly appear that, great as is the total activity in the study of published reports as a basis for estimating future earnings, far greater is the activity in the study of the corresponding private accounting reports, by the managements of companies, engaged in endeavors to increase the earnings and improve the position of their companies. The two viewpoints are not necessarily the same, and it would be possible to point to a number of accounting questions having their origin in these different purposes.

PRIMARY QUESTIONS FOR ACCOUNTING RESEARCH

Considering accounting research as somewhat different from accounting, I should like to submit that the fundamental

types of question to which it should find answers are questions as to *why* certain accounting practices are followed, rather than *what* accounting practices are followed. The latter information is, of course, a necessary preliminary to the former, but it is only a preliminary. It is interesting to know what proportion of companies showed marketable securities at cost or at current market values; but if in each case we knew the reasons, it would then be possible to judge whether the practices are satisfactory or not. Furthermore, knowledge of these reasons would enable a company which was considering that question with reference to its own marketable securities to determine into which of the different situations its own case fitted, and thus to determine the statement of its own marketable securities on a reasoned basis, rather than by counting cases which might have been very different.

It also more and more appears that the great questions for accounting research have to do with capital and income as reflected on the credit side of the accounts, even more than with the assets which appear on the debit side. Both sides of the balance sheet are, of course, involved, but the difficult and intricate questions are concerned with assigning the items between capital and income. It is for this reason that the statement of fixed assets on the asset side is not primarily a question of valuation of those assets, but a question of the rate at which they are to be written off against income, thus diminishing the capital except insofar as it is recovered from income. Similarly, the statement of inventories is not so much a question of valuation of them as assets or property; rather it is a question of the allocation of charges between different periods. For this reason, the cost-or-market rule has grown up, saying in effect that, if unsold goods are on hand at the balance-sheet date, they may in general be carried forward as a charge to the succeeding period; but if any impairment of their value has already appeared, as evidenced by their replacement cost or realization price, then this part of the charge should be made against the year in which such impairment developed. This rule is sometimes criticized as having only the sanctions of precedent and conservatism to support it; but if it is considered from the viewpoint of the allocation of charges, it has more of logic behind it than at first appears.

These and a great variety of other questions turn upon the effect of the required adjustments upon capital or income. This means that, if the nature of capital and income could once be agreed upon, it would furnish the key to the treatment of most accounting questions, and we would have the means of measuring capital and income.

SPECIFIC QUESTIONS AND MORE GENERAL QUESTIONS

Another problem arises as to the types of question with which accounting research can or should deal. Should it proceed first to deal with questions of large and general import, or with smaller questions of limited and specific application? It is argued by some that one should begin at the top, so to speak, and tackle first the distinction between capital and income, while others contend that this may best be dealt with by considering specific cases such as bond discount, premium paid on redemption of preferred stock, plant write downs, and so on. By coming to satisfactory conclusions on these smaller items, they say, the lines of the larger subjects will gradually appear. But others fear that when these lines do appear, they may be found to be inconsistent, and not to result in a well-balanced, general picture. In some ways, this is another variation of the old conflicts in logic between the inductive and the deductive methods.

The ideal answer obviously lies in a judicious combination of the two. A continuous and extensive research program will find itself called upon to deal with both types of question. In the research work of the American Institute, it has been judged best to deal first with one or two topics of somewhat specific character, for two main reasons. One has already been indicated, namely, confidence in the method of proceeding from the specific application to the general principle, which must be so drawn as to accommodate the specific applications. The other reason is the more prosaic one of finding out in the early stages how the organization of a large committee, served by a research department, can most effectively function. Having gained experience on small points, it is likely that larger matters will be undertaken in the near future. Already the committee is being urged to take up studies of surplus, of inventories, of depreciation, of the meaning of "cost" as applied to fixed assets. All these questions, and many more, will undoubtedly receive consideration in due course. The attention of the committee will in part necessarily be directed by affairs of the moment, as in the case of Bulletin No. 4 on "Foreign Operations and Foreign Exchange." It was necessary to get this out before the end of the year if it was to be of any real value. But it would be unfortunate if the committee became preoccupied with emergency matters of this kind for a large proportion of its time.

EXTENSION OF THE SCOPE OF ACCOUNTING

Reference has been made to the very considerable sentiment that exists to the effect that the general scope of the work of the accountant, so far as it furnishes published financial statements, should be widened. In a good deal of writing this has taken the form of demands for statements of "real values," for some restatement of property values in terms of current price levels, or present replacement values. When it is pointed out that to the economist, and indeed to the investor, "real values" would be the present worth of the future earnings, that also is agreed to in principle, though with a reluctant consciousness of the difficulties of converting that concept into precise figures of dollars and cents.

It would seem to be proper subject matter for accounting research to consider in what directions accountants might well extend their efforts. It is notable that in Great Britain accountants undertake other duties much more frequently than in this country, but those other duties are not necessarily undertaken as accountants, and they are not brought within the scope of accounting by being done by accountants. It is well at this point to remember the attention which the S. E. C. has devoted to the "independence" of the public accountant, and the rules it has laid down for the purpose of maintaining that independence unquestioned and unimpaired. It is not very likely that the Commission would regard an accountant as independent if he were acting as auditor of a company, and at the same time undertook to express opinions about the quality of the company's securities as investments. Nor would the work of engineering appraisers and valuers obviously harmonize with that of accountants. It is conceivable that these responsibilities could be undertaken by the same organization, and that such organizations may be required in the future. The difficulty is that suggestions of such undertakings too often emanate from people not too well acquainted with any of the work they are discussing.

MATERIALS FOR ACCOUNTING RESEARCH

Where should the research man find the materials which he can use as evidence

which might contribute to the solution of questions, and what evaluation should he put upon the several kinds of material which may be available?

To a group of teachers it is natural to think early of textbooks in accounting principles, though most of us would probably be unwilling to call them the raw materials of research. It is, however, worth while to find out what is said about the questions under consideration by those who have given a great deal of thought to them in the process of academic writing. Too frequently it happens, however, that such statements are so general that either they do not deal with the specific points at issue, or the connection between the principles stated and their application to particular situations is not clear. They form, however, a starting point of which most research workers are glad to avail themselves.

The regulations and findings of government bodies concerned with tax administration, public utility regulation by Federal and state authorities, and the Securities and Exchange Commission's concern with information for investors, form a vast mine of information. It is here, however, that the student needs to be particularly on his guard with reference to the point of view expressed or implied in the proceedings being studied. Tax cases, for example, hinge first upon the concepts of Congress as to a just distribution of the general tax burden among different classes of taxpayers, and second upon facilities for the administration of the collecting agencies. While, therefore, it is understood that there is a broad correlation between the definitions of capital and income followed by the Internal Revenue Department with those of the accountant, yet there are many points of difference between the formulas used in the two places. Mr. Dohr's article in *The Journal of Accountancy*[1] furnished a number of striking examples. Similarly, the accounting practices prescribed by Federal and state commissions engaged in the regulation of public utilities, are apt to reflect theories of public-utility regulation, with special reference to how much a public utility should be permitted to earn; again there is a considerable area of coincidence with general accounting principles, but by no means a complete identity. Moreover the systems of different jurisdictions conflict, as shown by Mr. Horne[2] and others. It would seem that the S. E. C., interested as it is in having true statements of earnings and of financial condition furnished to the public, must come nearest to the accountant's concept of the most desirable set of accounting principles. If any conflict should arise here, it must originate in some different conception as to the purposes of accounting statements, or in the method of best serving those purposes. In the latter area the principal cause of dispute is likely to be the question of the amount of information which may usefully be supplied to investors. Here the conflict normally lies between the point of view on the one hand that all additional information is to the good and on the other hand that there is a point at which all essential information has been furnished, and that beyond this point comes a period of rapidly diminishing returns from additional information provided. If one tries to visualize a research activity which would furnish the answer to such a question one is led to resort to the opinions of investment bankers, investment counselors, and other agencies of organized or institutional investment. Such a question is not susceptible of a quantitative answer; it calls for opinion testimony as to the value to an investor of various items of information. This in turn forms part of a larger question as to the value of the financial statements

[1] December, 1938.

[2] *The Journal of Accountancy*, November, 1938.

as a whole, as compared with other kinds of information such as the ability of the management and the future of the industry. It is easy to contend that each part of the information should be as accurate and reliable as it can be made; but there is also a question of setting up all the material information in a right proportion to the total amount of time which even careful investors can devote to the making of any investment.

Federal and State laws, and still more the Court decisions by which these laws are interpreted, are necessarily of interest to the accountant, and therefore to the research worker in accounting. Here again there is a large question as to the applicability of findings to situations other than those in which they arise in the first place. Court decisions are aimed in two main directions: they endeavor on the one hand to make what the court regards as a correct interpretation of the relevant statute, and on the other hand they seek to do essential justice between the parties in the light of the circumstances of each particular case. The dangers of inferring conclusions from court decisions, in circumstances different from those before the court, are too well known to need discussion here.

Another great source of information for research workers in accounting is the published annual statements of companies. Different research projects may be prosecuted upon a study of the annual reports of a single company for a series of years, noting both the changing facts and also the changing methods of presenting them. Other projects may undertake to compare or contrast the treatment of given items in different statements, and perhaps observing the relative prevalence of each of the several treatments. This question is a form of research which calls for more than quantitative measurement; to be conclusive as an indication of a basis for accounting policy it should ascertain the reasons for the different practices by the different companies, and should consider the suitability of the treatment in those circumstances, and in what circumstances that treatment would become unsuitable. As a practical fact, few people have the material and the resources for very extensive studies of published annual reports. It would be helpful if more studies of this kind[3] were publicly available, even though, for the reasons already indicated, the findings would have to be used with care.

SOME RESEARCH QUESTIONS

The general considerations here expressed will be made more real by referring to one or two of the research studies recently undertaken, not so much to discuss their findings as such, but rather to consider the types of argument which arise, and the kinds of consideration upon which conclusions were based.

Unamortized Discount on Bonds Refunded. Bulletin No. 2 dealt with the disposition of unamortized bond discount on bonds refunded. After enumerating three possible methods of disposing of an unamortized balance when bonds are retired, namely an immediate charge-off against surplus, spreading it over the remaining life of the old bonds, and spreading it over the life of the new bonds, the committee recommended that the first two be regarded as acceptable but that the third be treated as unacceptable. The first method, the immediate charge against surplus, would be the natural conclusion from a specific interpretation of the completed-transaction theory of accounts. The other views rest upon the assumption that although the specific old bonds were retired, yet by refunding new bonds have taken their place; in effect there has been merely a substitution of new debt for old, and essentially, it is said, there has been a con-

[3] I have in mind, of course, *Financial Statements*, by M. B. Daniels, as one type of such studies.

tinuous transaction. It is then argued by some that if the original transaction were not completed at the retirement of the old bonds, but were continued by the refunding operation, the continuation extends over the full life of the new bonds, and that therefore it is logical to spread the unamortized discount over the life of the new bonds.[4] But the question is not only to determine how long the original transaction may be regarded as continuing, but also the just apportionment of charges over the different periods. The answer to these questions may be found in the considerations upon which the refunding operation was based. These assuredly contemplated that, in considering whether to continue with the old bonds or to substitute new ones by refunding, the mathematical calculation would be based upon a comparison of the cost of those two alternatives for the term of the existing bonds, stated on a present-worth basis. If for the existing term refunding could be effected at a lower present-worth cost than that of the old bonds, it would be financially desirable.

Mr. Freeman argues that this is not the full extent of the consideration given to the subject when a refunding is under discussion, but that directors also contemplate the advantages of having their financial arrangements settled on a satisfactory basis for a longer period ahead than the term of the old bonds. This is true; it is natural and proper that directors should consider this aspect of the matter, in addition to the profitableness of the substitution. But this rather clearly introduces another factor, namely the advisability of making a present commitment for a period beyond the term of the old bonds. If that is deemed to be desirable, it will be upon the grounds that the directors do not expect to be able to provide for the financing of that future period on any better terms than the rates now available. This present rate is therefore the rate which should be charged to that period beyond the termination of the old bonds; the unamortized discount on the old bonds has nothing to do with that future period beyond their maturity date.

As between the immediate charge-off, and spreading over the remaining life of the old bonds, the latter has the advantage of passing the entire amount of charge through the income account, a proceeding which is being held to be of more and more importance. There is also in mind a consideration of public policy in the form of a public demand that accounting practices shall be simplified by the reduction of the number of possible alternatives, and the elimination of unnecessary procedures, insofar as this can be effected without doing violence to particular situations.

If one considers by what research methods such conclusions as these may be reached, it is evident that the effect of any factual information which might be introduced about specific accounting practices is limited. It runs to enumerating the three alternative methods; it might be of interest to know in how many cases each method was followed in practice. But these cannot be regarded as controlling; a more fundamental attack on the problem must be made by considering first the basis on which intelligent business management would deal with the question of refunding, and second the effect which generally accepted accounting rules might be expected to have upon their deliberations. A general requirement to write off the unamortized discount immediately against surplus would tend to confuse the picture for them either by possibly making a desirable piece of financing look undesirable, or even by making it look more desirable than it really was. On the other hand this practice

[4] This point of view is particularly well expressed in the letter of Mr. Herbert C. Freeman in *The Journal of Accountancy* for December, 1939, pp. 397–399.

has been shown to have other advantages which make it a permissible alternative. A requirement to spread the unamortized discount over the remaining life of the old bonds concentrates attention on where the advantage or disadvantage of refunding really lies; it coincides with the mathematics of the problem. The extension of the term of the new bonds beyond that of the old bonds introduces a new consideration which, while a valid one for the management to consider, has nothing to do with the old bonds; therefore it is again confusing to undertake to spread the old discount over the entire life of the new bonds.

Foreign Operations and Foreign Exchange. It was at first thought that it might be possible, in the bulletin with this title, to indicate which subsidiaries, on the basis of their countries of location, could be consolidated with American accounts; subsidiaries located in Canada or South America, for example, might be consolidated, while no others could be. A study of the situation, however, and conversations with the foreign-exchange departments of banks, and with companies doing a foreign business, quickly showed that this was impracticable. Other than the decline in most foreign currencies the most general fact confronting us at this time is that the restrictions placed by foreign countries on the export of funds are exercised in the form of scrutiny of each individual case, and the issuance of permits in those cases in which the authorities are prepared to allow money to be sent out of the country. These permits are issued or refused for all sorts of reasons, and it is impossible to make any general rule which attempts to state by countries which subsidiaries may be consolidated, and which may not. Bulletin No. 4, therefore, contents itself with pointing out those considerations which would justify the inclusion of foreign subsidiaries in consolidated statements, and those which would forbid their inclusion. These considerations turn upon such points as:

(1) The availability of the proceeds of foreign operations to American companies.
(2) The safety of the foreign assets, both as regards their possible physical destruction in war, and restrictions making them unavailable to American owners.
(3) The amount of information available from the foreign subsidiaries, stated in their respective currencies.
(4) The certainty or reliability of the rates of exchange at which these foreign statements may be converted into dollar statements, for incorporation in American accounts.

The first general question involved here is that of the basis of consolidation. When are consolidated statements helpful and desirable? When are they misleading? There has long been a trend toward consolidation; the event of war, by raising doubts as to the propriety of including foreign subsidiaries in American statements, really raises the issue of what justifies consolidation. A consolidated balance sheet ignores the legal divisions between the constituent companies; it may ignore other conditions in which they stand in a different light. The implication of the consolidated balance sheet is that all the assets there listed are equally available to the American creditor and owner. It needs no argument to show that that proposition calls for reëxamination.

The second general question is, once more, that of the disposition of charges or losses, having regard to their somewhat abnormal character and amount, and also to the distinction between losses realized on remittances, and unrealized losses on the conversion of working assets held abroad. Charges against income versus charges against surplus came up for discussion, and this, indeed, formed the most difficult single issue on which to formulate a statement. This classic dilemma was handled by pointing out, in plain terms,

that no one figure should be accorded undue importance as earnings per share, but that the entire story is essential to a full understanding.

The committee has under consideration a paper about the combined income and surplus statement. It is not possible at this date to say what form this might ultimately take, but it is almost certain to reiterate the note sounded in Bulletin No. 4, that neither statement is complete without the other. I doubt if the committee is likely to accept the heroic proposal to allow no charges against surplus. The simplicity of that proposal is attractive, but it would, I fear, be misleading in its ultimate effects.

DEPRECIATION ON APPRECIATION

This is a subject to which the committee has devoted a good deal of consideration but on which it has not yet reached final conclusions as to the terms of a statement to be published. I refer to it therefore, as a subject in what might be regarded as an intermediate stage. In discussing the question the committee will probably indicate that it does not thereby recognize the desirability of placing appreciation on the books; on the contrary it is clear that cost is the generally accepted basis of property accounts, and it would seem that the influence of the S.E.C. will tend to increase the general recognition of that basis. The Commission has not yet made clear its position on the question whether or not it would accept appraised values, provided they were fair and reasonable. In many of the numerous cases in which the Commission has discussed appraisals it has been able to show that the appraisals were unfair and unreasonable, and has rejected them on that basis.

After a property has been written up on the basis of an appraisal two main questions arise with regard to the subsequent accounting. The first concerns the amount of depreciation to be charged, and the accounts affected. The second relates to the treatment of the appraisal credit, subsequently to the date of the appraisal entry in the books.

There is still some difference of opinion on the first question. Many accountants hold that entering the new appraised values in the books has the effect of setting up a new carrying value which ought to be the basis for computing depreciation, the whole of which ought, they think, to be charged against income. They consider that consistent accounting between the balance sheet and the income statement requires such a treatment, that it is not consistent to assert the higher values in the balance sheet while charging depreciation on the lower values in the income statement. The contrary view is that the new value does not really supersede cost, that it is merely a representation of the management's opinion of the present value of the property which, however, need not or should not govern the amount of depreciation to be charged; or at any rate that it need not determine that the whole amount of depreciation should be charged against income. Various forms of stating the charge have been suggested, including two separate items charged in the income account, and also the charging of depreciation on cost in the income account while charging depreciation on appreciation against the appraisal credit.

This leads into the second question, as to the subsequent disposition of the appraisal credit. Should it be "frozen" on the books, i.e., continued there indefinitely, unless transferred to capital stock by the declaration of a stock dividend? Or should it on some basis be gradually transferred to earned surplus? Two bases for doing the latter have been suggested: (1) to transfer from the appraisal credit to earned surplus the amount of depreciation computed on appreciation, as it is periodically charged; (2) to transfer appropriate amounts from

the appraisal credit to earned surplus as the appraised items of plant are retired and charged against reserve for depreciation. In either or both of these cases, it is claimed, the appraisal credit has been "realized" as earned surplus.

Once more our immediate interest here is not to reach a conclusion but to inquire upon what basis a conclusion might be reached. Should the majority practice govern, or is it possible to arrive at basic considerations, the force of which either is, or may become, generally recognized, and which if generally accepted would determine the issue? It seems clear that the latter is much the preferable attitude. A combination of the two methods would be accomplished if we could discover the reasons which have in different cases led to one practice or the other, and from among these reasons select those which seem to be most satisfactory and conclusive. This takes us back to the original idea already referred to that the real criterion is what in the long run will work best, all things considered.

On these questions I venture to express the personal opinion that in the long run this conception of consistency between balance-sheet values and the related amortization charged is important, essential in fact to the general acceptance of accounting figures. A contrary idea, that one value may be claimed in the balance sheet and another and smaller value depreciated in the income account could not long, it would seem, continue to command the general confidence. There is the further idea that the company, having made these representations of value, may be regarded as morally committed to maintain that much capital value out of charges against income. This would seem to accord with the general notion which the S.E.C. is endeavoring to establish, that accounts must be such that current investors may safely invest upon the basis of the representations there made, and that the company is more or less obligated to live up to those representations. No statement of the Commission has perhaps expressed the situation in quite these terms, but it comes to pretty much the same thing when they ask accountants to remember that investors are constantly acting upon the basis of the accounts. If company officials wish to answer that the appraisal figures are merely an expression of their opinion as to present value; that they are not intended to supersede cost, but only to serve as additional information to the cost figures; then that would seem to point to the desirability of a notation on the balance sheet of the appraisal figures, and not to incorporating them in the balance sheet in lieu of cost.

Somewhat similar reasoning applies to the second question about the subsequent treatment of the appraisal credit. The root of the difficulty here is that in many cases in which appraisal values have been entered on the asset side, the corresponding credit has been recorded without a determination, on the part of the company officials, of its exact nature. It is of course an equity item of some sort—the question is "what sort?" If it is determined to be in effect a restatement of capital, it does not seem reasonable to transfer it later to earned surplus.

Again I would point out that, for purposes of this paper, I am not trying to settle these issues themselves, but rather using them as examples of the types of reasoning upon which answers to accounting controversies must be found. I would sum up by saying that we must acquaint ourselves with the facts of practice, and with the circumstances in which these practices are used. But much more, we must continually try to learn the reasons why these practices are followed, and be prepared to judge these practices in the light of those reasons, the criterion being what in the

long run will work best for the general interest.

Those of us who pretend to anything at all along the lines of accounting research cannot ignore the idea which bobs up from time to time, that accountants should try to devise a presentation of their data in entirely new forms. As a practical matter accountants do well to go slowly about this, and the constantly increasing pressure of regulation tends to freeze the forms we have. Even when no specific forms are prescribed, it is natural for business men to stay within the forms they know will be accepted. But there is no reason why we, as academic men, should not give ourselves the intellectual pleasure of speculating on the subject. I personally find it fascinating, and have promised myself a chance to take a fling at it some day.

ACCOUNTING RESEARCH IN THE SECURITIES AND EXCHANGE COMMISSION

Andrew Barr

In its study of accounting problems the Securities and Exchange Commission has a much broader objective than many other governmental agencies whose work requires the use of financial data and the proper application of accounting principles. The primary responsibility of the Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934, in respect to the financial data required to be filed with the Commission and made available to the public in accordance with the provisions of these Acts, is to insure that such information constitutes a "disclosure fully adequate for the protection of investors." The Public Utility Act of 1935 and Chapter X of the Chandler Act go further, however, and impose regulatory and advisory duties upon the Commission, in respect to public utility holding companies and corporate reorganizations, the performance of which depends to a very large extent upon correct accounting analysis for a proper solution of the problems presented.

It is clear that the Commission, even if it desired to do so, could not escape an obligation to make a thorough study of all accounting problems arising in its work and to do so with investors' needs in mind at all times. In fact, the necessity for this was foreseen by the framers of the first of the series of Acts now administered by this agency of the government. Section 19(a) of the Securities Act authorizes the Commission "to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income," and certain other details of accounting procedure. Similar authority is granted by the Securities Exchange Act of 1934 (Section 13(a)) and by the Public UtilityAct of 1935 (Section 14). The Public Utility Act also requires the Commission to prescribe the form and manner of account keeping for public utility holding companies, mutual service companies and their subsidiaries.

There are no prescribed principles of accounting laid down in these sections. However, Schedule A under Section 7 of the Securities Act, while leaving the detail and

form of the balance sheet and profit-and-loss statement to the Commission, specifies that the nature and cost of all of the assets, wherever determinable, and how and from what sources the surplus was created, shall be shown. The schedule requires that the profit-and-loss statement shall show "the character of the charges, dividends or other distributions made against its various surplus accounts, . . . and if stock dividends or avails from the sale of rights have been credited to income, they shall be shown separately with a statement of the basis upon which the credit is computed." Although these provisions, and one in the Public Utility Act to the effect that the Commission may require that the cost of assets, wherever determinable, be shown if deemed "necessary or appropriate in the public interest or for the protection of investors or consumers" may suggest a preferred treatment, there is no absolute requirement other than for disclosure.

The manner in which these accounting requirements have been applied by the Commission has been described before accounting societies on numerous occasions by members of the Commission and by the Chief Accountant. These addresses are available to the public, but it may be helpful now to review some of the matters discussed during the last few years, as an indication of the trend of the Commission's thinking on the subject of accounting principles and the emphasis placed upon the necessity for giving investors adequate and correct financial information.

In January, 1935, Commissioner Mathews, in discussing[1] the then recently issued Form 10 and its accompanying instruction book, expressed his opinion on an accounting problem upon which much research has been done both within and without the Commission. At that time he said that he did not believe that a balance sheet could properly or practically attempt to reflect current values of fixed assets and that to attempt to do so from year to year would involve the accountant in conjecture which might lead him to run a substantial risk of making misleading statements. In the summer of 1937[2] Judge Healy endorsed historical cost as the proper basis in accounting for utility properties. In December, 1938,[3] Mr. Werntz described some of the difficulties encountered with statements of industrial companies in which fixed assets had been recorded at appraised values and predicted that continued study of the problem would lead to rules dealing with the subject. And this fall[4] Chairman Frank, in discussing the importance to the investor of prospective net earning power, stated that the investor wants to know cost because cost is "useful to him in making an estimate of what the company's property can and probably will yield—that is, its earning power." The Chairman at the same time suggested that the investor may in many cases need something more than financial statements on a historical cost basis. Active open discussion of problems such as this by members of the accounting profession and an exchange of views between accountants and the Commission and the Commission's staff stimulates thinking and is an important factor in reaching a correct solution.

Another persistent problem is the question of uniformity in reporting methods and in the application of accounting principles. The requirements of the Public Utility Act were met by prescribing uniform systems of accounts for public utility holding companies, mutual service companies and subsidiary service companies. No attempt has been made to prescribe uniform accounting for the operating sub-

[1] January 18, before the Illinois Society of Certified Public Accountants.

[2] August 31, at the Annual Meeting of the National Association of Railroad and Utilities Commissioners.

[3] December 14 and 16, "An Approach to Accounting Problems."

[4] October 10, 1939, "Accounting for Investors."

sidiaries, however, since the accounts of such subsidiaries ordinarily are prescribed by other governmental agencies. This latter decision recalls a provision of both the 1933 and 1934 Acts to the effect that "the rules and regulations of this Commission shall not be inconsistent with the rules of the Interstate Commerce Commission in respect to the same subject matter." The full meaning of this provision was an issue in the Missouri Pacific Railroad Company proceeding[5] in which it was decided by the Commission that the Interstate Commerce Commission's failure to enforce a provision of its classification of accounts requiring the disclosure of contingent liabilities did not prevent the Securities and Exchange Commission from requiring such disclosure which it deemed necessary for the protection of investors. The conduct of a case such as this and the preparation of the opinion require extended public hearings, including the securing of the opinions of expert witnesses, and a thorough study of legal and accounting authorities. Work of this kind is an important part of the accounting research carried on by the Commission.

In the case of industrial companies, the Commission has been reluctant to prescribe hard and fast rules governing the form of financial statements and the accounting principles controlling their preparation. Experience under the Acts, however, early disclosed that steps had to be taken to insure that even some of the most elementary principles of accounting were applied uniformly by all accountants. This condition led Commissioner Mathews to say in January, 1937:[6]

> I think that a governmental agency should frame rules to govern the exercise of professional functions only when the need for such rules has been shown to be of real public importance. Mere preference of the administrative agency for one method or form is not a sufficient reason for taking the formulation of principles and practices out of the hands of the members of a profession, and where the profession gives evidence of its capacity and willingness to develop and apply proper methods without evasion or undue delay, it should be encouraged to take on the responsibility. If the profession fails in its public duty to recognize and apply adequate standards, I believe the agency whose duty it is to administer laws such as the Securities Act must eventually move in.

And in December[7] of the same year the address of Judge Healy before the Association at Atlantic City aroused considerable comment in professional circles. His paper described a number of situations in which disclosure of improper accounting practices of registrants was acquiesced in by the certifying accountants, but since there was a full disclosure of the procedures followed the statements were accepted. Judge Healy felt that, if an earnings statement and a balance sheet reflected the results of improper accounting, they amounted to misrepresentation or misleading statements in violation of the Securities Act, and that the statements should not have been accepted even though disclosure had been made.

The idea just expressed was put into effect when the Commission adopted a statement concerning its administrative policy with respect to financial statements and published it as Accounting Series Release No. 4. Reduced to its essentials this release says that the accounting principles followed must have authoritative support but that if a difference of opinion develops between the Commission and the registrant, then despite a marshaling of authorities behind the registrant's opinion, a previously published rule, regulation or other official release of the Commission, including the published opinions of its Chief Accountant would be controlling.

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[5] Securities Exchange Act of 1934, Release No. 2325.

[6] January 8, before the Milwaukee Chapter, Wisconsin Society of Certified Public Accountants.

[7] December 27, 1937, "The Next Step in Accounting," ACCOUNTING REVIEW, March, 1938, p. 1.

It is in the controversial field suggested by this release that extensive accounting research is necessary, for there is a definite suggestion here that a marshaling of the authorities may not produce a correct result in every case. Inertia and expediency have a tendency to preserve long established practices after they have been proven inconsistent with sound theory. The necessity for much research grows out of this condition as was recognized by Commissioner Mathews when he said,[8] "a . . . reason why accountancy has not more nearly fulfilled its possibilities is the tendency to rely on precedent and authority rather than the scientific method. The competitive nature of the profession and its traditional affiliation with management makes the acceptance of precedent dangerous. . . . The field for research in accounting seems to me to be a huge one. Practicing accountants should have a part in this research and colleges and universities should have a place in it comparable to that which they occupy in other fields."

An important example of the application of the principle laid down in Release No. 4 is found in the development of forms for promotional companies. Form A-O-1 appeared after two and one-half years of experience with situations such as those presented in the Unity Gold case in which stock issued for a mine was donated back to the corporation and resold at a discount. State law sanctioned the familiar procedure and certain accounting texts condoned it while others and expert witnesses disapproved. The Commission's disapproval was subsequently accepted by the American Institute of Accountants as an addition to a list of five rules or principles previously published. The unique features of Form A-O-1 are the presentation of assets and liabilities in a series of schedules rather than in a balance sheet; the showing of capitalized expenses and assets other than current assets in terms of *units* of securities, *amount* of cash and an *indication* of anything else given in exchange without extending the dollar amounts; and a statement of receipts and disbursements rather than a profit-and-loss statement. This procedure is considered by some to be a radical departure from accepted accounting procedure but nevertheless results in what appears to the Commission to be a proper disclosure of the facts and avoids the disarming inference of accuracy of values conveyed to many by the balance-sheet form. This is only one example of the many situations known to accountants in which insistence by the client upon a strict legal interpretation of transactions in the accounts and financial statements may lead to a flouting of economic realities of much greater significance to investors.

Two years ago Judge Healy discussed the work being done in revising the forms.[9] One result of this research is nearing completion in the form of a regulation designed to secure a uniform application of accounting principles in all of the major forms used under the 1933 and 1934 Acts. In this connection, a research project of the statistical variety may be mentioned. The census of American Listed Corporations is a Works Progress Administration project sponsored by the Securities and Exchange Commission. Fifty-five of the reports on separate industries have been announced. The explanatory notes accompanying the balance sheets give some indication of the difficulties encountered in making the data comparable for firms in the same industry, because of the diverse accounting practices followed. In fact, the reports state that no general attempt was made to adjust individual statements of various registrants so as to make accounting treatments uniform although certain adjustments were made to improve year-

[8] Address of January 8, 1937, see f. 6, *supra*.

[9] *Supra*, note 7.

to-year comparability of individual registrants. The first adjustment mentioned is that "Deficit" carried as an asset has been transferred to surplus accounts. Why should accountants countenance a practice which makes such a note necessary? Treasury stock carried as an asset, and valuation reserves whether deducted from assets or included among liabilities were left as reported unless the practice of the registrant changed. These three difficulties, at least, will be avoided when the new regulation becomes effective, for uniform treatment of these matters, long advocated by many accountants, will be required.

Another weakness in the reports is found in the use of incomparable fiscal periods by companies in the same industry and what is more important the use of unnatural closing dates. This is one subject on which most accountants are satisfied that the research is complete in so far as the general conclusion is concerned. All that remains to be done is to convince corporation officials that it would be to their own advantage to adopt their natural business year, and to continue the studies designed to disclose the proper closing date for each industry. An analysis of 2500 annual reports filed with the Commission shows that 80 per cent are on the calendar-year basis. It should not be necessary to reiterate the necessity for a change which is so universally recognized to be desirable and which would aid investors in appraising the results of operations of companies in the same line of business.

It has been said that the corporate form of doing business must serve a useful social purpose. If that is true it would appear desirable that the results attained by corporation managements should be reported on a sufficiently uniform basis of accounting principles to permit economists and other students of society to judge which corporations, which industries, and if all combined, are serving that useful social purpose.

The December, 1939 issue of *The American Economic Review* contains two articles which show clearly the pitfalls in the path of the economist who tries to use corporation reports as a basis for research. One article attempts to compare earnings ratios of selected American and European corporations. Despite the author's recognition of certain major differences in accounting policies and the impossibility of adjusting for all of them, he concludes from his figures that equity capital has constantly been appraised lower in America than abroad. The other article deals with corporate surpluses, income and employment, and is in rebuttal of a discussion of the same subject in an earlier issue of the *Review*. These articles suggest two ideas: first, that since economists use the results of corporate accounting for studies such as these (and such use fortunately is increasing) accountants have a further incentive to clarify and to apply uniformly the principles controlling their work so that scientists, as well as investors, who rely on the results, may not be misled; and second, that a correct use of accounting terminology by the economists would improve the presentation of their conclusions by eliminating unnecessary debate over the meaning of technical terms.

The requirements of Release No. 4, previously referred to, and the last paragraph of the usual auditor's certificate which states that the financial statements are prepared in conformity with generally accepted accounting principles are the cause of most of the day-by-day accounting research carried on by the Commission's staff. The problem is to discover whether a challenged practice followed by a registrant is in fact generally accepted. This may be done by a mere counting of cases if others can be found, or by a listing of authorities if the problem has received atten-

tion before, or by asking representative accountants to come to the Commission's assistance. Having started on the subject in one or all of these ways it does not seem to us that it is enough to determine only that the principle is generally accepted. The problem must also be subjected to the test of logical analysis to determine whether the principle applied is sound. The help of authorities and responses to inquiries, if reasons for opinions are given, aid in judging whether our office analysis has been logical and resulted in a sound conclusion.

This method of dealing with individual problems as they arise has been necessary because of the pressure of work which has prevented the formulation of a statement of the basic principles involved. The method is vulnerable to attack unless it can be assumed that the basic principles are so well known to all accountants that it is unnecessary to reduce them to writing. The "Tentative Statement of Accounting Principles Affecting Corporate Reports," published by the American Accounting Association, and publications of the American Institute of Accountants have been useful guides pending further refinement.

The "Tentative Statement" says that accounting is "not essentially a process of valuation, but the allocation of historical costs and revenues to the current and succeeding fiscal periods." The Institute's statement opens with the sentence, "The distinction between capital and income, which everyone recognizes and the economist attempts to state with refined accuracy, is fundamental in accounting." And Chairman Frank in speaking to the Controllers' Institute stated that "So far as the investor, in the corporations whose securities are listed or registered, is concerned, accountancy, in my opinion, should have but one *ultimate* objective—to disclose the reasonably prospective net earning power of the enterprise." These basic ideas are not in conflict. The Commission is vitally interested in determining and gaining general acceptance as rapidly as possible for those principles of accounting which have definitely proved their worth in clearly stating for the investor the effect of business transactions and will assert its influence and exercise its authority to attain that objective.[10]

In formulating a statement of accounting principles as a guide, it would appear that the following points must be kept in mind:

1. The necessity for a definition of corporate income.
2. The determination of what constitutes an adequate display of significant financial information to supplement the income statement.
3. The determination of the amount of and method of displaying the equities of the various classes of creditors and investors in the corporation.
4. The necessity for proper recognition and reconciliation of the basic economic and legal principles involved.

Accounting research in the Securities and Exchange Commission is guided by the very practical purpose of insuring that financial statements supplied to investors shall be presented on a consistent basis and in accordance with sound accounting principles. Optional accounting treatment of business transactions may be accepted only so long as the results obtained by such methods result in clear and unambiguous financial statements. The law requires this and the rules, regulations, and opinions of the Commission have been and will continue to be dictated by the necessity for disclosure fully adequate for the protection of investors.

[10] Address of Commissioner Mathews, Columbus, Ohio, May 20, 1938.

CONVENTION REPORT

American Accounting Association
Proceedings of the Twenty-Fourth Annual Convention
Philadelphia, Pennsylvania
December 28–29, 1939

The twenty-fourth annual convention of the American Accounting Association was held at the Adelphia Hotel, Philadelphia, Pennsylvania on December 28–29, 1939. The program was as follows:

First Session—9:30 a.m., December 28

Chairman: John K. Mathieson, President, The American Institute of Accountants
Topic: Accounting Research
Papers:
"The Relation of Accounting to Social Science Research," Ralph C. Epstein, Dean, School of Business Administration, University of Buffalo
"Research in Accounting," Andrew Barr, Chief Accountant's Office, Securities and Exchange Commission
"Accounting Research—Objectives and Methods," Thomas H. Sanders, Harvard University; Director of Research American Institute of Accountants

Second Session—2:00 p.m., December 28

Chairman: E. L. Kohler, Controller, Tennessee Valley Authority; Editor, the Accounting Review
Topic: Federal Accounting Practices
Papers:
"Recent Developments in Federal Administrative Practices," Herbert Emmerich, Associate Director of Public Administration Clearing House
"Federal Account-Keeping," John B. Payne, Head of the Control Accounts and Reports Section of the Department of Agriculture
"Proposals for Changes in the Federal Accounting System," Harvey Mansfield, Professor of Political Science, Stanford University

Third Session—6:30 p.m. Annual Banquet and Business Meeting

Reports of Officers and Committees

Fourth Session—9:30 a.m., December 29

Chairman: Ralph C. Jones, Yale University
Topic: Controllership Problems
Papers:
"What is Controllership?" V. L. Elliott, Controller, The Atlantic Refining Company
"Training for Controllership," W. P. Fiske, Massachusetts Institute of Technology
Discussion:
Ross G. Walker, Harvard University

Fifth Session—2:00 p.m., December 29

Chairman: Carman G. Blough, Arthur Andersen & Co., Chicago, Illinois
Topic: Accounting Principles
Papers:
"Fixed and Variable Costs," Robert L. Dixon, University of Chicago
"Debt Discount and Expense," Warner H. Hord, Tulane University
"A New Form of Funds Statement," H. L. Kunze, University of Wisconsin
"Should Obsolescence be Separately Accrued?" C. A. Moyer, University of Illinois
"Treasury Stock," Calvin H. Rankin, University of Pennsylvania

The business session was called at 8:00 p.m. on Thursday, December 28.

President Winter opened the session with the following remarks:

"We are assembled in the twenty-fourth annual convention of this group. We have come to the end of our fourth year as the American Accounting Association. It is customary for the president to present to the annual meeting some report of the Association's activity during the year. It is on the record of the year 1939 that I wish to comment briefly.

"For the purpose of establishing a background against which to evaluate the current performance, it may be well for you to have some reminder of what has gone

before. In December of 1935 at New York, the American Association of University Instructors in Accounting was reconstituted as the American Accounting Association. At that time, four official purposes of the Association were enunciated: (1) To encourage and foster research in accounting and to publish or aid in the publication of results of research; (2) To develop accounting principles and standards, and to seek their endorsement by business enterprises, public and private accountants, and governmental bodies; (3) To promote studies of accounting as an agency of control of business enterprise and economic affairs in general; and (4) To improve methods of instruction and to demonstrate the social benefits of a more widespread knowledge of accounting.

"Prior to this current year, these purposes have motivated three major publications; the much debated "Tentative Statement of Accounting Principles Underlying Corporate Financial Reports," the monograph *Principles of Public Utility Depreciation* by Perry Mason, and the monograph *Financial Statements* by M. B. Daniels.

"At the present time there is in galley proof the Association's monograph number three, *An Introduction to Corporate Accounting Standards*. This monograph is the work of the Association's directors of research, W. A. Paton and A. C. Littleton. Consideration of this manuscript has been one of the principal activities of the executive committee during the year. It has been an item of major importance at each of the four meetings of the committee held at Chicago and the subject of extended correspondence between and among committee members. It is the judgment of the executive committee that this monograph should appear before publication of a revision of the Tentative Statement of Accounting Principles. Some progress on this revision has been made in addition to that reported a year ago at Detroit.

"I am particularly pleased to be able to report three facts in connection with the Association's monographs. The first is that monograph number two, *Financial Statements* by M. B. Daniels, has enjoyed a large sale. It is significant to note that these sales have not been restricted to single copy transactions. Several colleges and universities have made use of this work in classes and in seminars. One university alone has ordered some six hundred copies. Two state societies of certified public accountants, Michigan and Wisconsin, and the Los Angeles Chapter of the California Society have made free distributions of this monograph to their respective memberships. The second is that in line with the Association's purpose of attempting to secure 'a more widespread knowledge of accounting' the executive committee has authorized a free distribution of monograph number three to the members of the Association. It is my earnest hope that the financial position of the Association will continue to warrant similar distributions of later monographs. The third, and, in some respects, the most important fact is that there is before your executive committee a proposal of the executive committee of the American Institute of Accountants looking toward the Institute's making a free distribution of monograph number three to the members of the Institute. This proposal has been approved in substance and there remains only the settling of relatively minor details. The completion of this project will supply concrete evidence of the ability and willingness of the two organizations to cooperate in the development of their common field.

"Other matters have received the attention of the executive committee. Considerations of importance have been the increasing of our membership and of the circulation of the ACCOUNTING REVIEW. For

the second successive year the subscription and advertising incomes of the REVIEW have been more than sufficient to cover the costs of publication. The Association continues to be indebted to contributors to the magazine for the excellence of the articles submitted and a full measure of credit should be accorded Mr. Kohler, the editor, and Mr. Chamberlain who is responsible for the business management of the publications of the organization.

"During the year, Mr. Werntz, the Chief Accountant of the Securities and Exchange Commission, has continued to submit accounting opinions for comment of the executive committee. It is hoped that he has found this practice sufficiently worth while to warrant his continuing it in the future and that the Association may render some small measure of public service through this channel.

"You will learn from the report of the secretary-treasurer that the Association has enjoyed a very successful year financially. The performance of the ACCOUNTING REVIEW has already been mentioned. Our membership has reached the high point of nine hundred and thirty-seven. This figure is net after allowing for resignations and lapses effective on December 31st. I have the privilege of announcing the addition of five names to the life membership roll, Messrs. Dohr, Filbey, Krebs, Morey, and Noble.

"All in all, we may feel with considerable confidence that this is a year to which we may well 'point with pride.' With a minimum of energy devoted to such "pointing" it may be better for us to consider some of the things which remain to be done, particularly some of the tasks which will never be fully completed.

"In the work of the membership committee, under the able leadership of Daniel Borth Jr., it was discovered that in two states there was not one member of the Association. In many states the representation is entirely too small. Many teachers of accounting have yet to join forces with the Association. Many practitioners, friendly in attitude and stimulating critics, are not on the membership roll. The work of maintaining and increasing the membership of the Association cannot be entirely the business of the membership committee. It is in large measure the business of each member of the Association. I do not wish to lower this report to the 'slogan level' but I earnestly bespeak your individual good offices in furthering the work of the membership committee.

"Another task which is largely that of our individual members is the maintaing of the excellence of the ACCOUNTING REVIEW. Articles suitable for publication in the REVIEW are always wanted. May I take, this opportunity to emphasize this fact to teachers, private accountants, governmental accountants, and public practitioners alike. There is, in my judgment, no better outlet for articles at once stimulating, provocative, scholarly.

"In the development of accounting research the Association stands ever ready to lend all help within its power. Coöperation with any and all interested individuals or groups or associations is assured. It was the hope of those who were instrumental in changing the character and name of the Association in 1935 that the Association would ultimately become the one organization recognized as most fully representing the study of accounting as a field of learning. The attaining of that goal is worthy of the best effort of our membership."

Report of the Secretary-Treasurer

Secretary-Treasurer Chamberlain presented a report of the membership and of the financial condition of the Association which is included in the auditor's report. The Secretary pointed out that four new

life members were secured subsequent to the publication of the membership list on November 15, 1939. These new life members are: James L. Dohr, Edward J. Filbey, William S. Krebs, Howard S. Noble.

In view of the financial condition of the Association the members present unanimously approved the transfer of $1500.00 from the General Fund to the Life Membership Fund.

Membership Committee

Chairman Borth reported on the work of the membership committee the results of which are shown in Schedule H of the auditor's report.

Committee on Nominations

Chairman Scovill submitted the following report:

"Because of a departure from procedures of the past, your committee wished to make comments relative to its deliberations and the principles which served as a basis for its conclusions.

"1. During the four years since the reorganization of the Association, it apparently has been the idea of nominating committees that a substantial majority of the officers and members of the executive committee should be so located geographically as to permit of frequent conferences which seemed to be desirable in formulating and carrying out policies implied in the creation of the American Accounting Association. Accordingly, such majority was selected from those living in the north central states.

"2. It seems that the purposes and policies are now established to such an extent that a wider geographical representation on the executive committee is desirable.

"3. Factors to be taken into consideration in nominating a person for president are (a) the standing of the individual in the accounting world, (b) the interest he has taken in the Association and its predecessor organization, (c) the standing and reputation of his institution in accounting and allied fields, (d) geographical areas. With these four elements entering into the selection of a nominee, it is considered impossible to derive any formula, or pattern, to follow in preparing a composite measuring-stick by which ultimate value of such nominee to the Association can be determined.

"4. Vice-presidents should be selected not necessarily with the idea that all or even any of them will be promoted in direct line of ascent to the presidency.

"There are so many well qualified members and so many institutions of high rank that a more rapid turnover of vice-presidents is recommended as a means of extending more widely the official family of the Association.

"This can be accomplished if a vice-president is elected for a one-year term instead of a three-year term; in other words, if two or three new vice-presidents can be selected in each year instead of only one.

"5. In suggesting such a policy of rapid rotation in the positions of vice-presidents, your committee recommends that nominees for the presidency in the future be made from some one who has served the Association some time in the past as a vice-president or other responsible member of the executive committee such as secretary-treasurer, editor or research director.

"Your committee nominates for the year 1940, the following officers: *President:* George A. MacFarland, University of Pennsylvania. *Vice Presidents:* L. J. Buchan, Tulane University; O. R. Martin, University of Nebraska; Victor H. Stempf, Touche Niven & Company, New York City. *Secretary-Treasurer:* H. T. Chamberlain, Loyola University, Chicago.

Editor, ACCOUNTING REVIEW: Eric L. Kohler, T.V.A., Knoxville, Tennessee. *Directors of Research:* A. C. Littleton, University of Illinois; H. F. Taggart, University of Michigan."

(Signed) Hiram T. Scovill
Wm. A. Paton
Roy B. Kester

Mr. Scovill moved the above persons be placed in nomination for the positions mentioned (along with any others who might be nominated from the floor) and that the other items in the report be adopted. Motion carried unanimously. It was moved and seconded that the president be instructed to cast a unanimous ballot for the election of officers nominated. After asking for other nominations and receiving none, President Winter put the motion and it was passed unanimously.

President Winter thanked the officers and committee members who worked with him during the year.

Henry T. Chamberlain

Report of Auditor

American Accounting Association:

I have made an examination of the accounts and records of your treasurer, Henry T. Chamberlain, for the year ended December 31, 1939. All records were found to have been carefully prepared and to be in good order.

The accompanying statements of the Association, namely,

Fund	*Exhibit No.*	*Title*
General	I	Balance Sheet as at December 31, 1939
General	II	Statement of Income and Expense for year ended December 31, 1939
Life Membership	III	Balance Sheet as at December 31, 1939
Life Membership	IV	Statement of Income and Expense for year ended December 31, 1939

correctly set forth, the financial position as at December 31, 1939 and the operating results for the year ended that date for each of the funds.

(Signed) HARRY D. KERRIGAN
Northwestern University
January 19, 1940

EXHIBIT I

American Accounting Association
Balance Sheet—General Fund
December 31, 1939

Assets		
Cash		$2,145.56
Dues receivable	$ 237.00	
Less reserve for bad debts	211.20	25.80
Subscriptions receivable	$ 84.75	
Less reserve for bad debts	38.80	45.95
Advertising receivable		434.75
Equipment		22.00
Total assets		$2,674.06
Liabilities and Net Worth		
Deferred dues income		$ 253.00
Deferred subscription income		800.08
Net worth:		
Balance December 31, 1938	$1,673.83	
Net income for the year ended December 31, 1939	1,447.15	
	$3,120.98	
Less transfer to Life Membership Fund	1,500.00	1,620.98
Total liabilities and net worth		$2,674.06

EXHIBIT II

Statement of Income and Expense—General Fund
for the Year Ended December 31, 1939

Income:		
Dues income	$3,509.00	
Subscription income	2,372.83	
Advertising income	1,312.30	
Miscellaneous income	1.15	$7,195.28
Expense:		
ACCOUNTING REVIEW	$3,612.44	
Executive committee expense	736.16	
Secretary's compensation	350.00	
Editor's compensation	350.00	
Printing, postage and stationery	364.16	
Convention expense	58.80	
Clerical expense	45.00	
Bad debts—dues	91.20	
Bad debts—subscriptions	43.61	
Miscellaneous expense	96.76	5,748.13
Net income (Exhibit I)		$1,447.15

EXHIBIT III

Balance Sheet—Life Membership Fund
December 31, 1939

Assets		
Cash		$3,568.60
Accounts receivable—monographs	$ 36.90	
Less reserve for bad debts	14.70	22.20
Total assets		$3,590.80

Net Worth

Contribution of life members		
Balance December 31, 1938	$1,675.00	
1939	320.00	$1,995.00
Transfer from General Fund:		
1938	$ 500.00	
1939	1,500.00	2,000.00
Deficit:		
Balance December 31, 1938	$ 39.26	
1939 net loss	364.94	404.20*
Total net worth		$3,590.80

* Deduct.

EXHIBIT IV

Statement of Income and Expense—Life Membership Fund for the Year Ended December 31, 1939

Income:		
Sale of monographs	$1,373.90	
Interest on bank deposits	11.50	$1,385.40
Expense:		
Cost of printing monograph #2	$1,439.93	
Royalties	134.58	
Bad debts—monographs	20.10	
Executive committee expense	91.80	
Miscellaneous expense	63.93	1,750.34
Net loss (Exhibit III)		$ 364.94

Note: No credit appears in the above statement for inventory on hand.

SCHEDULE 1

Analysis of Membership
For the Year Ended December 31, 1939

Number of members at December 31, 1938		714
Former members reinstated in 1939		2
New members:		
Secured in 1939 starting in 1939	287	
Secured in 1939 starting in 1940	1	288
		1,044
Decreases:		
Resignations in 1939	24	
Deaths in 1939	5	
Dropped in 1939	38	67
Balance, Membership at December 31, 1939		937

THE ACCOUNTING EXCHANGE

QUALIFICATIONS REQUIRED BY LAW OF C.P.A. CANDIDATES

The general use of a C.P.A. certificate as a means of measurement or recognition of an accountant's ability has become so widespread, and the certificate so coveted on the part of most accountants that it would seem as if all who are interested in the profession should be aware of the requirements for the certificate in the various states. In fact, a knowledge of the accounting law and of the regulations imposed by the administrative board in each state is probably the first requirement of any potential applicant.

Each of the forty-eight states, as well as the territorial possessions, have an accountancy law which specifies the requirements for the certificate and which provides for either a university committee or a state board of accountancy to make further regulations and to administer the law. An examination of these laws and regulations reveals a uniformity in some requirements and a wide variance in others.

The most uniform provisions in all states relate to the candidate's citizenship, his moral character, the examination, and the granting of reciprocal certificates. All states require an applicant to be a citizen of the United States or to have duly declared his intention of becoming naturalized. Likewise, all states require that an applicant be a resident of the state in which the application is made. There are, however, divergent meanings given to the term "resident." Some laws definitely state that an applicant must have lived within the state for one year prior to the date of application. Other states merely mention residence without specifying any length of time. Many of the laws read, "be a legal resident or have a place of

business in the state." Some read, "or be employed in the state."

All states require a candidate to be of good moral character. The applicant is usually required to furnish three or more affidavits or references to indicate this quality.

Since all but eight states[1] now use the standard examination of the American Institute of Accountants, there is a high degree of uniformity throughout the country with respect to examination subjects. The following is a brief syllabus of the Institute's written examination:

First Day—First Session—Auditing, 3½ hours.
First Day—Second Session—Accounting, not less than 5 hours.
Second Day—First Session—Commercial Law 3½ hours.
Second Day—Second Session—Accounting, not less than 5 hours.

In the states which do not use the Institute's examination, the laws provide for examination in the above subjects and occasionally in additional subjects among which are governmental accounting, principles of economics, and public finance.

Provision is made in each state for re-examination of those applicants who pass certain subjects in the examination but fail in others. In general, such candidates are permitted to sit for a subsequent examination although the laws and regulations vary somewhat with respect to the length of time that may lapse before the first and later examinations.

Provision is also made in nearly all the states for granting reciprocal certificates to those who already hold certificates in other states. Here again the provisions vary, but in general they require that the applicant must have secured his certificate in a state where the rules and regulations are at least equivalent to those of the state in which he applies for the reciprocal certificate.

[1] Kentucky, Maryland, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Wisconsin.

Among the provisions in which there is the greatest lack of uniformity among the states are those which pertain to the candidate's age, education, and experience. Reference to the age requirements of the various states shows that forty-one states and the District of Columbia have set the minimum age at twenty-one. Only Washington has a lower age limit of nineteen. Four states, Arkansas, Kentucky, Missouri, and New Mexico, have set the limit at twenty-five. While these are the minimum ages at which certificates will be issued, there have been court decisions in some states which enable applicants to take the examination before reaching the age limit in which case certification is withheld until the applicant reaches the required age.

Educational and experience requirements are often interwoven. However, in all the states except Texas the minimum educational requirement is high-school graduation or its equivalent. It is usually up to the state board to determine what constitutes the equivalent of a four-year high-school course. In many cases, provisions are made for examination in high-school subjects to help make this determination. The states of New Jersey and New York now require college work and after 1941 Kansas will require a minimum of two years of college study. Moreover, as noted below, many states are now waiving certain experience requirements in lieu of college training or graduation. The trend in this direction seems evident and when considered in conjunction with the three states which have recently passed minimum college requirements, indicates that basic background training for accountants is likely to be further increased.

The most variable requirement of all is that of professional experience. The following summary is of help in visualizing the most common requirements.

The above experience requirements rep-

Experience Required	States	Total States
More than three years public	Colorado (5), New Hampshire (4), Pennsylvania (5)	3
Minimum—three years public	California, Connecticut, District of Columbia, Florida, Georgia, Iowa, Kansas, Massachusetts, Minnesota, Nevada, New Mexico, Ohio, Oklahoma, Rhode Island, West Virginia, Wisconsin, Wyoming	17
Minimum—two years public	Alabama, Arizona, Maine, Maryland New Jersey, North Carolina, Oregon, South Carolina, Vermont, Virginia.	10
Either public or practical with minimum years if public with minimum years if practical	Ida. Ind. La. Miss. Tenn. Utah Nev. 3 3 2 2 1 2 3 5 3 3 5 3 3 3	7
Three years—at least two public	North Dakota, New York	2
Three years—at least one public	Kentucky	1
"Practical experience," with designated minimum years	Arkansas (3), Maryland (3), Missouri (3), South Dakota (1), Washington (3)	5
Miscellaneous: Submission of five year employment record No experience required High school or sufficient commercial experience One year's study and experience in accounting Four years, public or Either: Four years practical, or four years public plus an examination in practical accounting	 Delaware Illinois Montana Texas Michigan	5
States allowing college credit to count toward experience requirement	Colorado, Connecticut, District of Columbia, Florida, Georgia, Iowa, Louisiana, Maryland, Michigan, North Carolina, Pennsylvania, Rhode Island, Utah, Wisconsin, Wyoming	15

resent minimum essentials. However, in several of the states there are other specifications relating to the candidate's experience record. For example, some states require a certain amount of the time spent in public accounting work to have been in the capacity of a senior accountant. Other state laws specify that at least part of the experience be in the office of a C.P.A. Most states allow a candidate to take the examination before fulfilling the experience requirement but will delay certification until the latter requirements are met. On the other hand, some state laws specify that at least part of the work record be complete before the applicant takes the examination.

It is obviously impossible to outline requirements and regulations that will be in effect over a long period of time. Those interested are reminded that new laws and regulations are frequently passed by various states. In fact, the above chart includes revisions which a number of states have made within the last year. Information can always be secured by writing to the accounting board or committee of the particular state in which the candidate is interested or by referring to the *Accountancy Law Service*, a continuous loose-leaf service published by Commerce Clearing House. In all cases, it is desirable for students, teachers, and practitioners to note current changes and trends in the certificating standards of the profession.

LELAND L. MEDSKER

ACCOUNTING CASES

Homestake Mining Company: Unit Depletion, Percentage Depletion, Discovery-Value Depletion

The statements of the Homestake Mining Company, a gold-mining company, and of its wholly owned subsidiaries, the Golden Gate Mine and Timber Company and the Wyodak Coal and Manufacturing Company, provide an interesting example of the treatment of depletion and of the difference between percentage depletion allowed by the Federal income tax law and unit depletion based upon the cost or March 1, 1913 vaules of the property.[1]

The March 1, 1913 value of the ore body of the Homestake Mining Company was established by the Bureau of Internal Revenue for income tax purposes at $13,250,416.16. For a number of years depletion based on a percentage of gross income as permitted by the Federal income tax law (for example, Section 114 of the present Revenue Act) was credited partly to "Depletion reserve on cost or market value as at March 1, 1913" on a per-unit basis, and the remainder to "Depletion reserve—percentage basis in excess of cost or March 1, 1913 value." The latter is considered as a subdivision of surplus, as is a third depletion reserve "Depletion reserve based on discovery value in excess of cost or March 1, 1913 value." In 1936 the $13,250,416.16 was depleted finally on a per-unit basis, and subsequent depletion on ore bodies taken by the Homestake Mining Company in 1937 and 1938 has been credited exclusively to percentage depletion reserve. One of the subsidiaries, the Wyodak Coal and Manufacturing Company, has coal lands, and as in the case of the parent company, depletion is taken on a percentage basis. This depletion "is allocated in part to asset values subject to unit depletion and the balance is credited to percentage depletion reserve."[2] In the 1938 statements, "Depletion reserve on cost" had a balance of $999.25, while "Depletion reserve—percentage basis in excess of cost" had a balance of $33,910.02. Depletion of timber lands of the Homestake Mining Company and its subsidiary is provided on a unit basis.

In the accountants' certificate for the year 1938, the matter of depletion is covered in the following fashion:

> The statements of operations reflect depletion of ore as established on the percentage basis allowed for Federal income tax purposes, which has been carried to percentage depletion reserve. Depletion of coal properties has been established in the same manner and allocated in part to unit depletion and the remainder to percentage depletion reserve. Provision for timber depletion is on a unit basis. Depreciation on plants and equipment has been taken at rates considered adequate to retire these assets within the period of their useful life.
>
> In the balance sheets, properties, plants and equipment are stated at amounts representing 1913 values with subsequent additions at cost, less unit depletion on ore bodies, coal deposits and timber and after adequate depreciation on plants and equipment. The report of the General Manager for the year ending December 31, 1938, which is a part of the report of the company for the same year, shows 189,571 tons of ore broken down and remaining in stopes and a reserve of 18,558,019 tons of developed ore. The present value of the ore, coal and timber is not reflected in the balance sheets under the caption of properties, plants and equipment, either gross or net after depletion, inasmuch as the books of the companies are kept on the basis above stated and as the assets are not subject to interim appraisals.

As a result of these varying depletion methods, the following depletion reserves are found supporting the consolidated balance sheet as of December 31, 1938:

[1] SEC File 1-1235.

[2] Footnote to Schedule III accompanying 1938 statements.

	Depletion Reserves on Cost or March 1, 1913 Value	Depletion Reserves Based on Discovery Value	Percentage Depletion Reserves in Excess of Cost or March 1, 1913 Value
Homestake Mining Company			
Mining Property	$13,250,416.16	$144,605.81	$4,002,949.83
Timber Lands	135,700.54		
Golden Gate Mine and Timber Company			
Timber Lands	149,796.23		
Wyodak Coal and Manufacturing Company			
Coal Lands	999.25		33,910.02
Totals	$13,536,912.18	$144,605.81	$4,036,859.85

Dividends have been paid from all three classes of reserves. The dividends paid from depletion reserve as a return of capital are deducted from the capital stock account on the face of the balance sheet—in 1938 in the following form:

Capital Stock

Authorized and outstanding—2,009,280 shares of $12.50 par value	$25,116,000.00
Less: Dividends paid from depletion reserve (prior years) as a return of capital	7,220,997.71
	$17,895,002.29

This treatment is fully in accord with accepted accounting principles, and it is refreshing to find it so clearly presented.

As suggested earlier, the surplus of this company is made up of the surplus ac-

CONSOLIDATED SURPLUS

	Total Surplus	Surplus Account	Undistributed Depletion Based on Discovery Value	Percentage Depletion Reserve
1. Balances at beginning of fiscal year as per accounts	$3,081,906.70	$ 310,498.27*	$144,605.81	$3,247,799.16
2. Net income from profit and loss statement	6,940,848.13	6,940,848.13		
3. Other additions to surplus:				
Percentage depletion in excess of unit depletion charged to 1938 operations	2,890,076.34			2,890,076.34
Reduction in prior years' stripping expense—income tax adjustment	2,190.35	2,190.35		
Total	$12,915,021.52	$6,632,540.21	$144,605.81	$6,137,875.50
4. Deductions from surplus other than dividends:				
Additional income taxes for prior years	$ 915.66	$ 915.66		
5. Dividends				
(a) Cash dividends on stock—$4.50 per share on 2,009,280 shares	9,041,760.00	6,940,744.35		$2,101,015.65
Total deductions from surplus	$ 9,042,675.66	$6,941,660.01†		$2,101,015.65
6. Balances at close of fiscal year as per balance sheets	$ 3,872,345.86	$ 309,119.80*	$144,605.81	$4,036,859.85

* Indicates deficit or red figure.

† This total of $6,941,660.01 agrees with the net income of the Homestake Mining Company. The Golden Gate Mine and Timber Company had a loss of $1,440.34 and the Wyodak Coal and Manufacturing Company a profit of $628.46, resulting in the consolidated profit of $6,940,848.13.

The Homestake Mining Company (parent) had no balance in its surplus account at the beginning of the period, the consolidated deficit of $310,498.27 resulting from a deficit of $292,144.47 of the Golden Gate Mine and Timber Company and a deficit of $18,353.80 of the Wyodak Coal and Manufacturing Company.

The apparent policy is to declare dividends to the full extent of the earnings of the parent company (less surplus adjustments), and to declare additional dividends out of percentage depletion reserve.

count, undistributed depletion based on discovery value, and percentage depletion reserve. In this connection the statement of consolidated surplus for the year 1938 is of interest (see preceding page).

A change in the treatment of investments in subsidiaries by the parent company, required by the Securities and Exchange Commission, is also of significance. The original balance sheet as of December 31, 1937, submitted to the Commission, showed:

Indebtedness of Affiliates (Wholly Owned):		
Golden Gate Mine and Timber Company[a]	$832,148.89	
Wyodak Coal and Manufacturing Company[a]	405,729.03	
Total indebtedness of affiliates		$1,237,877.92

[a] This indebtedness is eliminated in the consolidated balance sheet.

After being returned for amendment, the balance sheet reflected the following changes:

Investment in Stocks of Affiliates (Wholly Owned) Consolidated—Schedule I:		
Golden Gate Mine and Timber Company—Note 1	$ 75,030.00	
Wyodak Coal and Manufacturing Company—Note 1	100,000.00	
Total investment in stocks of affiliates		$ 175,030.00
Indebtedness of Affiliates (Wholly Owned) Consolidated:		
Golden Gate Mine and Timber Company	$757,118.89	
Wyodak Coal and Manufacturing Company	305,729.03	
Total indebtedness of affiliates		$1,062,847.92

NOTE 1: At December 31, 1937, the registrant's investment in the stock of its wholly owned subsidiaries was not stated separately in its accounts, but the investment was represented in its account captioned "Indebtedness of Affiliates" which item did reflect the registrant's net investment in its wholly owned subsidiaries. On September 6, 1938 the registrant by appropriate action authorized the entries necessary to reflect separately in its accounts its investment in the stock of its wholly owned subsidiaries.

The Securities and Exchange Commission insisted not only that the balance sheet for 1937 be amended, but also that corresponding changes be made in the balance sheet for 1936. The latter statement was returned twice for amendment, and its final form, prepared just after the action of September 6, 1938 was taken, likewise showed the division of "Indebtedness of Affiliates" into two items, labeled respectively "Investment in Stocks of Affiliates" and "Indebtedness of Affiliates."

U. S. Industrial Alcohol Company: Reduction of Asset Values to $1.00 —Subsequent Capitalization and Depreciation Policy

A good example of the policy followed by many companies in the early thirties of writing down fixed-asset values in order to reduce or eliminate assets of doubtful value and to reduce depreciation charges is found in the history of the U. S. Industrial Alcohol Company.[1]

The United States Industrial Alcohol Company was incorporated in West Virginia in 1906 for the purpose of manufacturing and distributing pure, specially denatured, and completely denatured alcohol. Its operations were later extended into the field of organic chemicals largely derived from alcohol. The chief raw material used by the company is blackstrap molasses from the West Indies and Hawaii. The company markets the manufactured alcohol directly and through several of its wholly owned subsidiaries to

[1] Material derived mainly from SEC File 1-119, other references cited as used.

industrial users and as an antifreeze for use in internal combustion engines. Much of the alcohol is also sold to the U. S. Industrial Chemical Co., Inc., a wholly-owned subsidiary, which manufactures chemical derivatives of alcohol and other organic chemicals, such as solvents and plasticizers of various kinds.[2]

In the 1932 report of the U. S. Industrial Alcohol Company, the stockholders were informed that they would be asked at the next annual meeting to approve a reduction in the stated capital of the company, and a write-down of the fixed assets to the nominal amount of $1.00. The reasons given for such action by Chairman of the Board Charles E. Adams and President Charles S. Munson, as given in a letter to stockholders, were as follows:

> As the result of a careful survey of capital assets completed during 1932, the conclusion was reached that a restatement of the values of fixed assets was most desirable. The company is still carrying on its books at substantial values an excess of productive facilities, largely accumulated to serve war needs, and the requirements of the industrial boom period, and considerably more than is required for present needs. Furthermore, changes in the art are largely to render obsolete many of such facilities, before business again expands to the point where they might be of use. Under these circumstances, and in view of the radical change in values that all such assets have undergone in the past three years, the directors find great difficulty in establishing a conservative basis on which the fixed assets of the company and its subsidiaries should be carried. They have, therefore, concluded to recommend, with the approval of Messrs. Haskins and Sells from an accounting standpoint, that steps be taken to increase the property reserves in order to reduce the book value of all fixed assets of the company and subsidiaries to an arbitrary and nominal amount of $1. The cost of the fixed assets will continue to be shown on the consolidated balance sheet with the offsetting reserved deducted from such cost. In view of the impossibility of arriving at even an approximate valuation of plants under existing conditions, it is felt that an understatement of such values is the conservative course.
>
> Therefore, at the special and annual meetings of stockholders to be held April 20, 1933, you will be asked to approve and authorize the corporate action for the purpose of effecting, by two successive steps to be taken in accordance with the laws of West Virginia, in which State company is incorporated, the reduction of the stated capital of the company from $22,584,600 to $3,738,460, and thereby creating a capital surplus of $18,846,140. If this action is authorized, you will further be asked to approve the transfer of the capital surplus so created to property reserves, together with an additional amount of $454,903, which will be charged against earned surplus, the whole resulting, when reflected in the consolidated balance sheet, in the reduction of the net book value of the fixed assets to $1, as stated.
>
> As future depreciation charges will thus be eliminated, a "Reserve for Replacements" account will be set up, commencing with the year 1933, by a direct monthly charge against income of an amount deemed sufficient to provide for the replacement of productive facilities. It is believed that for the year 1933 an adequate amount of such charge will be $300,000, which may be compared with the sum of approximately $900,000 charged against income as depreciation in 1932.[3]

In accordance with these proposals, the stockholders of the company on April 20, 1933, approved a reduction of the stated capital from $22,584,600 to $3,738,460, which resulted in the creation of a capital surplus of $18,846,140. The fixed assets were then reduced from $19,301,044.63 to $1.00 by increasing the property reserves from $9,814,499.83 to $29,115,543.46, and $18,846,140.00 was charged to capital surplus and $454,903.63 to earned surplus. The effect of the change may be summarized by comparing the consolidated balance sheet as of December 31, 1932, with a pro forma statement as of the same date, after giving effect to the several proposals approved by the stockholders.[4]

[2] Answer to Question 10, Form 10, SEC File 1-119-1.

[3] *Commercial and Financial Chronicle*, Vol. 136 (1933), pp. 1393 and 1736-1737.

[4] *Moody's Manual of Investments*, Industrial Securities, 1933.

U. S. Industrial Alcohol Company
Consolidated Balance Sheet, as of December 31, 1932

Assets	Original Statement	Pro Forma Statement
Land, buildings & equipment (net)	$19,301,045	$ 1
Investments (at cost)	1,416,052	1,416,052
Cash	1,342,935	1,342,935
Notes, acceptances & accounts receivable (net)	1,400,223	1,400,223
Inventories	5,342,393	5,342,393
Miscellaneous assets	1,144,673	1,144,673
Prepayments and deferred charges	140,467	140,467
Totals	$30,087,787	$10,786,743
Liabilities and Net Worth		
Accounts Payable	$ 942,722	$ 942,722
Miscellaneous Accruals	252,179	252,179
Reserve for Contingencies	1,750,000	1,750,000
Reserve for Ship Repairs	99,968	99,968
Capital Stock	22,584,600	3,738,460
Earned Surplus	4,458,318	4,003,415
Totals	$30,087,787	$10,786,743

contingencies in 1935, inasmuch as actual expenditures exceeded the accumulated balance in the reserve for renewals and replacements by that amount.

With respect to fixed assets acquired since December 31, 1932, the policy has been to capitalize them and to charge off depreciation at rates based upon the estimated life of such assets.

As a consequence of these procedures, the profit-and-loss statement for each year contains two items: (1) "Renewals and replacements in lieu of depreciation," and (2) "Depreciation of property capitalized since January 1, 1933." For example, the figures for 1938 are $420,000.00 and $107,548.93, respectively, and the balance sheet on December 31, 1938, shows:

Fixed Assets—Land, Buildings, and Equipment Capitalized prior to January 1, 1933:		
Balance, January 1, 1933, less retirements	$21,308,107.73	
Renewals and replacements since January 1, 1933	3,090,942.65	
Total	$24,399,050.38	
Less reserves	24,399,049.38	$ 1.00
Capitalized since January 1, 1933	$ 3,136,142.66	
Less reserve	279,986.42	$2,856,156.24

After 1932, in lieu of normal depreciation on fixed assets, profits have been charged and a reserve for renewals and replacements credited with $300,814.00 (1933), $900,000.00 (1934 and 1935), $660,000.00 (1936), and $420,000.00 (1937 and 1938). In order to maintain the nominal book value of $1.00, as amounts are expended for renewals and replacements of fixed assets on hand December 31, 1932, the property accounts are charged with the expenditures, and a corresponding amount is transferred from the "unappropriated" reserve for renewals and replacements to the reserve for depreciation. The pursuance of this policy necessitated a charge of $252,717.07 to the reserve for

Both the accountants' certificates and the footnotes accompanying the profit-and-loss statement have undergone significant modifications during the period statements have been filed with the Securities and Exchange Commission. The certificate, prepared by Haskins and Sells, for the year 1935 read in part as follows:

> Following the reduction in the stated value of the common stock of your company to $10.00 a share, the resulting capital surplus of $18,846,140.00 together with earned surplus of $454,903.63, was applied as of December 31, 1932, to provide a reserve to reduce the net book value of the fixed assets of your company and its subsidiary companies to a nominal amount of $1.00. It has been the policy of the companies since December 31, 1932, to maintain the fixed assets

in existence at that date at a net book value of $1.00 by increasing the property reserves by the amounts expended for renewals and replacements of the fixed assets carried at nominal valuation. In lieu of normal depreciation based upon the useful life of those assets, the companies provided from income in 1935, $900,000.00 as a reserve for renewals and replacements. The excess of the expenditures for such renewals and replacements over the accumulated provision therefor at December 31, 1935, amounting to $252,717.07, has been temporarily charged to the reserve for contingencies.

In our opinion, based upon such examination and subject to the foregoing,[5] the accompanying balance sheets, profit and loss statement, and supplemental schedules fairly present, in accordance with accepted principles of accounting consistently followed by the companies, the financial condition of the registrant, and of the registrant and subsidiaries consolidated, as of December 31, 1935, and the consolidated results of operations for the year ended that date.

After being returned by the Commission for amendment, the certificate was changed to read:

Following the reduction in the stated value of the common stock of your company to $10.00 a share, the resulting capital surplus of $18,846,140.00, together with earned surplus of $454,903.63, was applied as of December 31, 1932, to provide a reserve to reduce the net book value of the fixed assets of your company and its subsidiary companies to a nominal amount of $1.00.

It has been the policy of the companies consistently followed since December 31, 1932, to maintain the fixed assets in existence at that date at a net book value of $1.00 by increasing the property reserved by the amounts expended for renewals and replacements of the fixed assets carried at nominal valuation. In lieu of normal depreciation based upon the useful life of those assets, the companies provided from income in 1935 $900,000.00 as a reserve for renewals and replacements. The excess of the expenditures for such renewals and replacements over the accumulated provision therefor at December 31, 1935, amounting to $252,717.07, has been temporarily charged to the reserve for contingencies.

In our opinion, based upon our examination, the accompanying balance sheets, profit and loss statement, and supplemental schedules, with the footnotes on certain of the statements, and schedules, fairly present, in accordance with accepted principles of accounting, except as set forth in the next preceding paragraph, consistently followed by the companies, their financial condition at December 31, 1935, and the results of their operations for the year ended that date.

It will be noted that the original certificate merely includes a general qualification and then states that accepted principles of accounting have been followed by the companies, but the amended certificate specifically excludes the depreciation policy from accepted principles. The wording adopted in the amended certificate for 1935 is retained in practically the same form in the certificates for 1936, 1937, and 1938.

The consolidated profit-and-loss statement for 1936 portrays an interesting evolution. The statement first submitted to the Securities and Exchange Commission was accompanied by the following notes:

(1) The amounts of gross sales, less internal revenue taxes, freight and allowances, and cost of sales (before provision for renewals and replacements and depreciation) are submitted separately as confidential information.
(2) No intercompany profits are included in the above statement.
(3) Maintenance and repairs, depreciation, taxes, etc., are detailed in Schedule X.

This statement, having been returned for amendment, came back the first time with the above three notes, to which was added a fourth:

(4) It has been the policy of the companies consistently followed since December 31, 1932, to maintain the fixed assets in existence at that date at a net book value of $1.00 by increasing the property reserves by the amounts expended for renewals and replacements of the fixed assets carried at nominal valuation. In lieu of normal depreciation based upon the useful life of those assets, the companies provided from income in the years 1935 and 1936, the amounts of $900,000.00 and $660,000.00

[5] This qualification presumably includes the acceptance of inventory certificates from officers, and a statement that the records of the companies were examined or tested "in a manner and to the extent which we considered appropriate in view of the system of internal accounting control."

respectively, as a reserve for renewals and replacements. The reserve for contingencies was temporarily charged at December 31, 1935, with $252,717.07 representing the excess of expenditures for such renewals and replacements for the year 1935 over the accumulated provision therefor at December 31, 1935. The rates used in providing a reserve for depreciation of buildings and equipment capitalized since January 1, 1933, are based on the experience of the companies as to the probable useful life of depreciable property, and are intended to extinguish the investment in such property at the expiration of such estimated period. The amounts of depreciation claimed for Federal income taxes for the years 1935 and 1936 are as follows:

	1935	1936
On fixed assets in existence December 31, 1932, and renewals and replacements thereof............	$1,587,790.92	$1,083,320.83
On fixed assets capitalized since January 1, 1933..............	32,828.51	49,698.83
Total...........	$1,620,619.43	$1,133,019.66

Returned a second time for amendment, the profit-and-loss statement was revised to include the figures for gross sales, internal-revenue taxes, freight outward, allowances, net sales, and cost of sales, thus indicating the derivation of the gross-profit-on-sales figure which was the beginning of the other two statements. The four notes referred to above were retained in this secondd amenment.

Since it may reasonably be inferred from the previously quoted remarks of the company's Chairman and President that one reason for writing off fixed assets was to relieve the profit-and-loss statement of a considerable portion of the normal depreciation charge, it may be significant to summarize the charges for renewals and replacements in lieu of depreciation, the depreciation of property capitalized since January 1, 1933, the total charges to income from these two sources, the depreciation deducted for income tax purposes, the excess of the latter figure over the former total, and the net profit or loss of the consolidated companies. The accompanying table does this for the years 1935 to 1938 inclusive, the only years for which complete data are available.

Year ended December 31	Provision for renewals and replacements in lieu of depreciation	Depreciation of property capitalized since January 1, 1933	Total charges to income	Depreciation claimed or to be claimed for Federal income-tax purposes	Excess of depreciation for tax purposes over total charges to income	Net profit or loss (before Federal income taxes) per profit-and-loss statement
1935	$900,000.00	$ 31,883.68	$931,883.68	$1,620,619.43	$688,735.75	$843,742.62
1936	660,000.00	49,698.83	709,698.83	1,133,019.66	423,320.83	77,581.07 Loss
1937	420,000.00	74,784.77	494,784.77	904,711.52	409,923.75	456,257.38 Loss
1938	420,000.00	107,548.93	527,548.93	878,249.40	350,700.47	667,656.52 Loss

While the excess of depreciation claimed for tax purposes over the charges to income indicated by the profit-and-loss statement has steadily declined, the amount is still substantial, being $350,700.47 in 1938. Had the depreciation figures for tax purposes been used in computing the net profit or loss, the reported profit for 1935 would have been reduced to about $155,000.00, while the losses for 1936, 1937, and 1938 would have been substantially increased in amounts ranging from $350,700.47 to $423,320.83. While there might appear to be a kinship to the old idea of varying depreciation charges with the operating results for each year, since the charges for renewals and replacements in lieu of depreciation have declined as the profit figure was converted into a loss and the loss increased,[6] such a conclu-

[6] This variation with reported income is still very pronounced if the available figures for 1933 and 1934 are added to the table, namely a provision for renewals and replacements of $300,814 in 1933 with a reported net income of $1,392,962, and a provision for renewals and replacements of $900,000 in 1934 with a reported net income (before Federal tax) of $1,705,067.

sion is not necessarily justifiable, since the depreciation claimed for tax purposes has also declined materially. This decline would tend to substantiate the contention of the officers of the company that many of the assets carried in 1932 were obsolete or otherwise overvalued. However, the discrepancy between the total charges to income revealed by the profit-and-loss statement and the depreciation claimed for tax purposes is still a very substantial one, and its justification is open to serious question. Despite the information revealed in the accountants' certificates and in the footnotes to the financial statements, the possibility of misleading the stockholder or prospective investor not well versed in accounting techniques would appear to be great. A comment appearing in the financial section of the *New York Times* at the time the reduction of fixed assets was proposed by the officers of the U. S. Industrial Alcohol Company may be worthy of quotation in this connection:

> The proposal of the U. S. Industrial Alcohol Company to write down the value of its fixed assets to $1 at the next meeting of stockholders recalls the heavy property writeoffs in the last year or two by many companies. However, none so far has been as drastic as those of United States Industrial Alcohol, which had net fixed assets, including land, buildings and equipment of almost $20,000,000 at the close of last year, according to the company's balance sheet. These heavy write-offs materially reduce charges for depreciation and at the same time increase the net earnings of the company. The practice in recent years has been to gauge the market value of a stock on earnings almost entirely. The practice of making large property write-offs, if carried to unreasonable lengths, might make it necessary to change this practice.[7]

MISSOURI PACIFIC RAILROAD COMPANY

Showing of contingent liabilities, arising out of contracts to purchase securities, on the balance sheet; effect of bankruptcy upon such disclosure

In Release No. 2325 under the Securities Exchange Act of 1934, dated December 6, 1939, The Securities and Exchange Commission charged that the Missouri Pacific Railroad Company (referred to thereafter in the release as MOP) in its registration statements failed to disclose a liability arising from contracts it had executed with Terminal Shares, Inc. (Both Missouri Pacific and Terminal Shares are subsidiaries of Alleghany Corporation.) By the terms of these contracts the Missouri Pacific agreed to purchase the securities of certain terminal and railway corporations for $15,965,201, plus interest, and an additional $4,369,062 to be derived from the income and liquidation of some of the securities. The Missouri Pacific agreed to buy these securities "when, as, and if" authorized by the Interstate Commerce Commission. In the event that the Missouri Pacific did not pay the purchase price before January 1, 1936, (e.g., in case the Interstate Commerce Commission refused to grant permission for consummation of the sale) the sellers could, with notice, dispose of the securities to other parties and the Missouri Pacific agreed to reimburse them for the difference if the sale price were below $15,965,201.

The Missouri Pacific was to deposit $400,000 every three months to the credit of the seller, beginning March, 1931, until the seller received $15,965,201 plus interest; no quarterly payments, however, were to be made after January 1, 1936. During 1931 and 1932 the railroad made these payments (totaling $3,200,000), and then discontinued them. The sellers acquired that portion of the payments representing interest and left the balance in trust.

The books of the Missouri Pacific for 1931, 1932, and 1933 did not account for a liability under the contracts; nor did the balance sheets reflect the existence of any liability under these contracts. But the quarterly payments were carried as cur-

[7] *New York Times*, February 24, 1933, "Topics in Wall Street."

rent assets under the caption "Special Deposits."

An exchange of letters with Director Wylie of the Bureau of Accounts of the Interstate Commerce Commission forced the railroad to adjust its books. Director Wylie first recommended that the railroad show the $3,200,000 deposit as a payment on the purchase of securities and not as a special deposit, and the unpaid purchase price as "Funded debt unmatured." The Missouri Pacific protested this treatment as contrary to the terms of the contracts, and was then advised to show the amount under "Other unadjusted debits," which it did. No attempt was made to obtain the approval of the Interstate Commerce Commission for the acquisition of the securities.

On March 31, 1933, the Missouri Pacific filed a voluntary petition under Section 77 of the Bankruptcy Act. The trustees retained the General Solicitor and the chief accounting officer and opened a new set of books. The financial statements to the Interstate Commerce Commission in 1935 and 1936 represented a composite drawn from the old and new books, and the quarterly payments were carried as an asset under "Other Unadjusted Debits." No other reference to the contracts was made;[1] thus the nature and amount of the liability were not disclosed.

The bankruptcy court, on the motion of the Reconstruction Finance Corporation, directed the trustee to bring suit to set aside the contracts and recover the payments. The judge sustained several contentions urged by the Reconstruction Finance Corporation, among them, the claim that the contracts were unfair because of harsh forfeiture provisions which were beyond the control of Missouri Pacific. (The judge also believed the contracts violated the Clayton Act and were therefore void.) The trustee instituted suits which are still pending. Shortly thereafter the trustee filed a notice of disaffirmance which the seller did not contest, and on July 22, 1936, the court barred all claims of Terminal Shares, Inc. (the seller) under the contracts.

In 1935 the Missouri Pacific filed an application for registration of securities with the Securities and Exchange Commission, and in 1936 and 1937 filed annual reports, the several documents containing balance sheets as of December 31, 1934, 1935, and 1936. Neither the financial statements nor supplementary documents contained any reference to the agreement to pay to Terminal Shares, Inc., even in case the Interstate Commerce Commission disapproved the acquisition, the difference between the agreed total price minus payments made and the price obtained by the seller at either private or public sale of the securities. As stated in the release, "Under the Securities Exchange Act of 1934 any company which desires to take advantage of the public trading market afforded to its securities by listing on a national securities exchange must make full and honest disclosure of all such facts concerning its business as are necessary to enable an investor to determine whether to buy, sell, or hold securities."[2] If the Interstate Commerce Commission Classification of Accounts is taken as constituting the criterion of appropriate disclosure for railroads, the Missouri Pacific clearly did not conform to the required procedure

[1] Schedule 228, the breakdown of "Other Unadjusted Debits," contained this explanation:

Name of Sub-Account	Character of Sub-Account
Payments made under Terminal Shares, Inc. contract	Payments made on contract to purchase property

Reason for Carrying Forward Balance	Amount at Close of Year
Transactions not yet completed	$3,200,000

[2] P. 6.

since the Interstate Commerce Commission prescribes that contingent liabilities "shall not be included in the body of the balance sheet statement, but shall be shown in detail in a supplementary statement accompanying the balance sheet."[3]

The Missouri Pacific argued that the annual report for 1935 did contain a full disclosure of the Terminal Shares contracts in the reorganization plan which was incorporated by reference in its application for registration. The Securities and Exchange Commission held that:[4]

> Assuming that the needs of investors would be served by complete disclosure in a reorganization plan of data omitted from a balance sheet, the present disclosure is nonetheless materially inadequate because of the failure to reveal the *nature* of the liability. The plan discloses payments made and a balance outstanding under a contract subject to any necessary Interstate Commerce Commission approval—approval that was never sought. But it failed to mention that MOP had contracted to pay any deficiency arising out of the sale of the securities by the vendor in the event with MOP for any reason did not complete the purchase . . . when . . . the contracts provided [that] the denial of approval might operate to accelerate the date when payment would have to be made . . . An investor was entitled to know that MOP had contracted that its parent would receive the full purchase price even though MOP would not be permitted to acquire the assets it had agreed to purchase.

Price, Waterhouse & Co. filed a brief on the propriety of Missouri Pacific's accounting since they had certified certain reports of the trustee to the stockholders which largely adopted the accounting of Missouri Pacific. Price, Waterhouse & Co. contended that the trustee would have been unwarranted in placing a fixed liability and a corresponding asset on the books as a result of these contracts, or in showing such a liability on the balance sheets. The Securities and Exchange Commission does not comment on this contention, since it held, and Missouri Pacific and Price, Waterhouse & Co. agreed, that the liability was contingent. Price, Waterhouse & Co. further contended that there is a distinction in accounting treatment of contingent liabilities between a going concern and an estate in bankruptcy. When a large company goes into bankruptcy, the "usual practice is to make no attempt to estimate the total contingent liabilities and to note on the face of the balance sheet that this has not been done."[5] This argument is overruled:[6]

> In the first place, the "usual practice" was not followed in the present instance, for the financial statements contained no notation that the total contingent liabilities had not been estimated. In the second place, the instant contingent liability, as appeared from the face of the contracts, was unusual in nature. It was also large; and it had an

[3] P. 8. "Leonard Ayres, investment banker, and a director of MOP said that if the liabilities were not disclosed *on the balance sheets* the latter would be inadequate, and that a failure to disclose a liability of that size would constitute an omission of the type of information in which prospective investors would be interested. J. P. Murphy, draftsman of the contracts, would have advised a client to disclose such a liability in the balance sheet, and he said that lacking such disclosure, a balance sheet would be materially incomplete." Release No. 2325, footnote 7, page 7.

The Securities and Exchange Commission also says, in connection with the statement that the Classification of Accounts of the Interstate Commerce Commission follows settled accounting principles:

"W. H. Bell, partner of Haskins & Sells (C.P.A.'s) and textbook writer, testified to this effect. R. E. Warren, partner in Lybrand, Ross Brothers & Montgomery (C.P.A.'s) labeled the contracts as commitments, which, if material and not in the regular course of business, should have been disclosed as a contingent obligation to the full amount of the purchase price in a footnote to the balance sheet. J. J. Anzalone, Comptroller of Alleghany, and an officer of Terminal Shares at the time the contracts were executed, said the terms of the contracts should have been disclosed in a supplementary statement to the balance sheet. Wm. Wyer, secretary and treasurer of MOP, who signed the application and reports filed with the SEC, said the liability was contingent, that under the Interstate Commerce Commission Classification of Accounts, the best accounting would have been a supplementary statement to the balance sheets, summarizing the contracts. Johnson, the MOP chief accounting officer, took a contrary position, in which he was supported by G. O. May, partner of Price, Waterhouse & Co., whose argument will hereinafter be separately discussed." Release No. 2325, footnote 8, page 7.

[4] *Op. cit.* p. 8.

[5] *Op. cit.* p. 11.

[6] *Loc. cit.*

important bearing upon the company's financial condition. Had the Interstate Commerce Commission requirements and sound accounting principles been followed, the contingent liability would have been disclosed in supplementary statements to the balance sheets prior to reorganization. And no valid reason is suggested why an accountant, aware that the contingent liability should have appeared in the financial statements prior to reorganization, should not disclose the liability after the company had come under the jurisdiction of a reorganization court. In the third place, the Interstate Commerce Commission has explicitly ordered that "each and every such carrier and each and every receiver or operating trustee of any such carrier be required to keep all said accounts in conformity" with the Classification of Accounts. The "usual practice," if it existed, could not be permitted to override the explicit regulation of the Interstate Commerce Commission which requires, even in the case of a railroad in process of judicial reorganization, that a contingent liability be disclosed in a supplementary statement to the balance sheet. Finally, were the evidence, contrary to the fact, to indicate that accounting theory has become so refined as to find it possible to justify the non-disclosure of the liability in question, there would be need to reëxamine and reshape that theory so as to bring it into line with business realities and a proper regard for the protection of investors.

Missouri Pacific argued that the Interstate Commerce Commission's requirement that the contingent liability be shown in supplementary statements had become a "dead letter" among railroad accountants and is not generally followed. But the Securities and Exchange Commission ruled that the evidence presented in support of this contention was inconclusive. "In any event it is settled that nonenforcement does not deprive a law or regulation of force and effect."[7] Besides, if this rule, or a similar rule, is not enforced, the result will be to create an area in which huge contingent liabilities may be hidden from the view of investors.

Missouri Pacific's chief other argument that the Securities and Exchange Commission cannot impose an accounting requirement inconsistent with instructions of the Interstate Commerce Commission is declared invalid because a regulation of the Interstate Commerce Commission exists which explicitly requires the disclosure of contingent liabilities.[8]

The Securities and Exchange Commission then sums up its ruling:[9]

> A failure to satisfy accounting requirements does not of itself necessitate the suspension or withdrawal of the registration of securities on a national securities exchange. Under the terms of the statute, such action is to be taken only if, in the opinion of the Commission, it is necessary or appropriate for the protection of investors. Under the circumstances of this case, it would not, in our opinion, be in the interests of the thousands of investors who now hold MOP securities to suspend or withdraw the registration of MOP securities if proper amendments to its balance sheets are filed by respondent.
>
> An order will issue withdrawing the registration of the MOP securities herein discussed unless MOP, within thirty days after the date of the issuance of this opinion, amends the application for registration and the annual reports in accordance with this opinion. If appropriate amendments are filed within that period, we shall enter an order dismissing the proceeding.

In conformity with the last-mentioned requirement, the Missouri Pacific on January 2, 1940, filed amended balance sheets, both for the parent company and for the system, and an amended Schedule 228 (Other Unadjusted Debits). The amended statements each contained a footnote reference "See supplemental statement with respect to contingent liability under Terminal Shares contracts," which supplemental statement follows in full.[10]

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[7] Louisville & Nashville Ry. v. United States, 282 U. S. 740, 759 (1930) cited, also Seeley v. Helvering, 77F. (2d) 323, 324 (C.C.A. 2d, 1935), and Standard Oil Co. v. Fitzgerald, 86F. (2d) 799, 802 (C.C.A. 6th, 1936). Release 2325, footnote 19, page 13.

[8] In addition, there were technical arguments concerning the jurisdiction of the Securities and Exchange Commission in comparison with that of the Interstate Commerce Commission which were overruled.

[9] *Op. cit.* p. 16.

[10] SEC File 1-2139-1-1 (Form 8), Amendment to Application for Registration on Form 12-A.

"This statement and the amended balance sheets and amended Schedule 228 for 1934 are filed to correct the deficiencies found to exist in the balance sheets by the Securities and Exchange Commission in its opinion and order of December 5, 1939, entitled 'In the Matter of Missouri Pacific Railroad Company, etc.' Release No. 2325, Securities Exchange Act of 1934.

"Account 727 of the closing balance sheets and Schedule 228, both entitled 'Other Unadjusted Debits,' contain an item of $3,200,000 having the following history:

"In January 1931, Missouri Pacific Railroad Company and Terminal Shares, Inc., both controlled through stock ownership by Allegheny [sic] Corporation, entered into four contracts calling for the purchase by Missouri Pacific of certain securities from Terminal Shares, Inc. Three of these contracts involved the purchase of the securities of certain terminal and railway companies, and of corporations owning property in Missouri, for a consideration of $15,965,201 plus interest, and an additional $4,369,062 to be derived from the income and liquidation of certain of the property. Each of the three contracts contained stipulations of which the following is typical:

" 'The buyer agrees to buy said St. Joseph stock when, as and if it shall be authorized by the Interstate Commerce Commission to acquire control of said St. Joseph Belt Railway Co.

" 'In case the buyer shall not for any reason complete the purchase of said St. Joseph stock and pay the purchase price hereinbefore stated on or before January 1, 1936, the seller may, and upon request of the buyer shall, at any time within one year after January 1, 1936, sell or dispose of said St. Joseph stock upon giving ten days written notice to the buyer, at public or private sale and upon such terms as the seller shall in its discretion determine. In case the net proceeds of any such sale, after deducting all expenses thereof . . . incurred by the seller in connection with said sale, shall amount to less than the purchase price of said St. Joseph stock as hereinbefore stated, the buyer agrees, upon written demand from the seller, to pay to the seller (as one of the considerations of this agreement) the difference between said purchase price and such net proceeds of such sale.'

"The fourth contract recited that the parties had entered into the three above described contracts, and provided that Missouri Pacific should deposit $400,000 every three months with the Guaranty Trust Company of New York to the credit of the seller, beginning March 1931, until the seller received $15,965,201.00 plus interest; no quarterly payments, however, were to be made after January 1, 1936. These deposits were to be applied against the purchase price relating to all the contracts. The fourth contract further provided that the seller might, upon the failure of Missouri Pacific to meet any quarterly payment, accelerate the date of purchase and upon Missouri Pacific's failure to complete the purchase in the new period, exercise rights of sale as outlined above.

"During 1931 and 1932, Missouri Pacific made the quarterly payments of $400,000 (totaling $3,200,000) to the depositary, which were applied against the interest and total purchase price. These payments, when received by the depositary Guaranty Trust Co., were disbursed in accordance with a trust agreement securing notes in the amount of $16,000,000 issued by Terminal Shares, Inc., to its parent, Allegheny [sic] Corporation. The contracts themselves were assigned as partial security for this note issue and Guaranty Trust Co., was trustee under the agreement. The trust agreement, which provided for the said disbursements and assignments, was dated one day later than the Missoure Pacific contracts with Terminal Shares, Inc. and was signed at about the same time in January 1931. The terms of the trust agreement required Guaranty Trust Co., to pay to Terminal Shares, Inc., upon demand, so long as no default existed, that portion of the quarterly payments which represented interest, and to use the remaining portions, at the request of Terminal Shares, Inc., for redemption of outstanding notes or for payment to Terminal Shares, Inc., on surrender of notes for cancellation. Payments were discontinued after December 1, 1932 and have not been resumed by Missouri Pacific. No acceleration has been declared by Terminal Shares, Inc.

"At no time has Missouri Pacific sought Interstate Commerce Commission approval of the purchase of these securities from Terminal Shares Inc. Nevertheless, due to the wording of the contracts, as above quoted, Missouri Pacific had, at December 31, 1934, a contingent liability to Terminal Shares, Inc., due to the possibility of sale in accordance with the terms of the contracts, of the subject matter of the contracts by Terminal Shares, Inc., after default by Missouri Pacific. The amount of such contingent liability would be measured by the difference between the full purchase price and interest mentioned in the contracts (less the payment of $3,200,000 heretofore made) and the amount which might be realized by Terminal Shares upon such a sale. The for-

feiture of the payments aggregating $3,200,000 is implied in the contracts upon default by Missouri Pacific and in the absence of a sale by Terminal Shares.

"Notwithstanding the default under the contracts with Terminal Shares, Inc., which occurred upon failure to continue the quarterly payments of $400,000, Terminal Shares has not sold or attempted to sell the securities covered by the contracts and the liability therefor remains contingent.

"On March 31, 1933, Missouri Pacific filed a voluntary petition under Section 77 of the Bankruptcy Act with the United States District Court for the Eastern District of Missouri and trustees in bankruptcy were appointed on June 22, 1933. Also on that date, during a hearing on the motion of the Reconstruction Finance Corporation for the appointment of an independent trustee, to investigate the prudency of the Terminal Shares contracts as well as for other reasons, the Bankruptcy Court, upon the motion of the registrant, ordered a special master to report on the execution, the value of the consideration, and the validity of the contracts between Missouri Pacific and Terminal Shares, Inc., in order that the court might determine whether the trustees in bankruptcy should be required to disaffirm the contracts and take such further steps as the facts might warrant. The report of the special master had not been made on December 31, 1934."

It is interesting to note that the first half of this supplemental statement follows almost word for word the text of part of Release No. 2325 of the Securities and Exchange Commission, even to the quotation of typical stipulations from the contracts.[11] As a result of the above amendments, the Securities and Exchange Commission, on January 4, 1940, issued an order dismissing the proceedings.[12]

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[11] Cf. pp. 2 and 3 of the release.

[12] Release No. 2368, Securities Exchange Act of 1934, released January 5, 1940.

PROFESSIONAL EXAMINATIONS

A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING problems were presented as the second half of the November, 1939 C.P.A. examination prepared by the Board of Examiners of the American Institute of Accountants. The candidates were required to solve all problems in six hours. The weights were as follows: problem 1, 10 points; problem 2, 25 points; problem 3, 30 points, and problem 4, 35 points.

No. 1

A, B, and C have been partners throughout the year 1938. Their average balances for the year and their balances at the end of the year, before closing the nominal accounts, are as follows:

	Average balances	Balances Dec. 31, 1938
A	Cr. $90,000	Cr. $60,000
B	Cr. 3,000	Dr. 1,000
C	Cr. 7,000	Cr. 10,000

The profit for 1938 is $75,000 before charging partners' drawing allowances and before interest on average balances at the agreed rate of 4% per annum. A is entitled to a drawing account credit of $10,000, B of $7,000, and C of $5,000 per annum. The balance of profit is to be distributed at the rate of 60% to A, 30% to B, and 10% to C.

It is intended to distribute amounts of cash to the partners so that, after credits and distributions as indicated in the preceding paragraph, the balances in the partners' accounts will be proportionate to their profit-sharing ratios. None of the partners is to pay in any money, but it is desired to distribute the lowest possible amount of cash.

Prepare a statement of the partners' accounts, showing balances at the end of 1938 before closing, the allocations of the net profit for 1938, the cash distributed, and the closing balances.

No. 2

On January 1, 1938, the Acme Carburetor Company acquired control of the Airex Manufacturing Company by purchasing 1,000 shares of preferred stock (the entire issue) and 8,000 shares of common stock (80% of the outstanding shares). The sole product of the Airex Company is an air cleaner which is used in the assembly of the carburetors manufactured by the Acme Company.

The machinery and equipment of the Airex Company was appraised as of January 1, 1938, at a net sound value of $300,000 representing reproductive value of $500,000 less accrued depreciation of $200,000. The books of the Airex Company were not adjusted to this appraisement, although the directors of that company had authorized the adjustment.

The purchase price of the above preferred and common shares was $400,000 and was based on the appraised value of the equity in fixed assets acquired and the book value of other net assets.

The following statement of trial balances of December 31, 1938, was presented:

Assets	Acme Carburetor Company	Airex Manufacturing Company	Combined trial balance
Cash	$ 75,000	$ 50,000	$ 125,000
Accounts receivable	150,000	100,000	250,000
Accounts receivable—Intercompany		25,000	25,000
Inventory	270,000	145,000	415,000

Fixed assets			
Land	$ 150,000		$ 150,000
Buildings	350,000		350,000
Machinery & equipment	700,000	$700,000	1,400,000
	1,200,000	700,000	1,900,000
Less—reserve for depreciation	366,500	256,000	622,500
	833,500	444,000	1,277,500
Investment in Airex Co. stock	400,000		400,000
Deferred charges	10,000	5,000	15,000
	$1,738,500	$769,000	$2,507,500
Liabilities and Capital			
Accounts payable	$ 75,000	$ 31,000	$ 106,000
Accounts payable—Intercompany	25,000	—	25,000
Common stock	750,000	10,000	760,000
Preferred stock	—	100,000	100,000
Earned surplus	700,000	559,000	1,259,000
Profit and loss			
Sales	1,500,000	850,000	2,350,000
Other income	10,000	—	10,000
	$1,510,000	$850,000	$2,360,000
Materials used	$ 800,000	$400,000	$1,200,000
Factory labor	200,000	125,000	325,000
Manufacturing expenses	221,500	206,000	427,500
Selling and general expenses	100,000	50,000	150,000
	$1,321,500	$781,000	$2,102,500
	$ 188,500	$ 69,000	$ 257,500
	$1,738,500	$769,000	$2,507,500

Depreciation had been provided by both companies at the rate of 3% on buildings and 8% on machinery and equipment.

The Acme Company's purchases from the Airex Company amounted to $350,000 in 1938 and at the end of the year $80,000 of these purchases were included in the Acme Company's inventory.

The common stock of both companies is of no-par value. The Acme Company has 7,500 shares outstanding and the Airex Company 10,000 shares. No dividends were paid in 1938 by either company on its common stock

The preferred stock of the Airex Company is 6% cumulative. Dividends have been regularly paid on June 30 and December 31 of each year and were charged to surplus.

Federal income and profits taxes need not be considered.

From the foregoing prepare a columnar work sheet showing the consolidated balance-sheet as well as the consolidated profit-and-loss account. Do not show eliminations and adjustments together, but use separate columns for each.

No. 3

On the petition of principal creditors, receivers in bankruptcy were appointed for the Skihigh Liquor Company on September 30, 1939. Appraisers appointed by the court took a physical inventory on the morning of October 1, 1939, finding the following merchandise on the premises:

	Cases of 12 bottles
Spirits	
Old Mahogany rye	40
Filibuster Special bourbon	10
Old Bluebottle	5

Wines:	
Sparkling muscatel	20
Beers:	
The Brewers Own	60

Accountants appointed by the receivers on October 1, 1939, found that the books had not been posted since September 15, 1939, when accounts had been prepared for the purpose of obtaining a bank loan. The trial balance of that date was as follows:

	Dr.	Cr.
Cash in bank	$ 500.00	
Petty cash	100.00	
Accounts receivable	7,609.66	
Accounts receivable—assigned	12,000.50	
Note receivable	190.00	
Note receivable—officer	300.00	
Advances to salesmen	6,000.00	
Inventories:		
Spirits	3,180.00	
Wines	360.00	
Beers	375.00	
Inventories—assigned	10,006.54	
Insurance, taxes and rent prepaid to Sept. 30, 1939	1,866.66	
Life insurance policy	4,000.00	
Notes payable—president		$ 2,000.00
Accounts payable		55,100.90
Accrued sales taxes		900.12
Capital stock		10,000.00
Deficit	21,512.66	
	$68,001.02	$68,001.02

On the basis of these accounts a loan of $5,000 was obtained from the bank on the agreement that accounts receivable collections (after September 15) be deposited in a special account at the bank, amounts to be withdrawn therefrom only as approved by the bank.

Cash transactions from September 15 to 30, 1939, were as follows:

Collections:	
Accounts receivable deposited in special bank a/c	$ 2,005.00
Accounts receivable—assigned—deposited in special bank a/c	12,000.50
Note receivable	190.00
Advances to salesmen	500.00
Proceeds of bank loan of $5,000	4,900.00
Total	$19,595.50
Disbursements:	
President's note payable	$ 2,000.00
Accounts payable	5,000.00
Liquor license for year to September 30, 1940	1,000.00
Advances to salesmen	1,000.00
Petty expenses (paid from petty cash)	100.00
Total	$ 9,100.00

An amount of $7,000 had been transferred from the special account to the regular drawing account as approved by the bank.

There were no purchases during the period from September 15 to September 30, 1939. Verified sales during the period, all on credit, were as follows:

	Cases	Per Case (net)	Total
Spirits:			
Old Mahogany rye	10	$30	$300
Filibuster special bourbon	5	20	100
Old Bluebottle	5	12	60
Wines:			
Sparkling muscatel	10	15	150
Beers:			
The Brewers Own	40	2	80
			$690

The perpetual stock records showed the following goods on hand at the close of business September 15:

	Cases of 12 bottles	Cost per Case
Spirits:		
Old Mahogany rye	100	$24.00
Filibuster Special bourbon	40	18.00
Old Bluebottle	10	6.00
Wines:		
Sparkling muscatel	30	12.00
Beers:		
The Brewers Own	250	1.50

Among the accounts payable of September 15, 1939, is a debt of $21,007.04 to a distillery, representing two successive shipments of $11,000.50 and $10,006.54. The first shipment had been sold for $12,000.50 and the customer's account pledged to the distillery as security. The second shipment had been stored in bonded warehouse, but the title to the goods was passed back to the distillery on September 28, 1939.

The life-insurance policy (surrender value at September 15, 1939, $2,500) was

on the life of the president of the company, but it had been assigned to his wife some years ago.

The receivers expect that the bank will attempt to attach all balances at September 30, 1939, and that also other creditors will assert their claims are preferential.

The attorneys appointed by the receivers request that you prepare at once a balance-sheet of September 15, 1939, on a going concern basis and a tentative balance-sheet of September 30, 1939, for purposes of a discussion on October 2, 1939. A report or memorandum containing full notes should accompany the balance-sheets so that the attorneys may be informed as to the facts so far determined.

No. 4

A manufacturer wishes to enter the hosiery knitting business but lacks sufficient capital. Hoping to obtain the necessary additional funds from temporary bank loans by indicating substantial potential profits, he has requested that the following projected statements or budgets be prepared by quarters, starting with the third quarter in 1940 and ending with the quarter in which it is estimated that all bank borrowings have been liquidated:

(a) Statements of cash receipts and disbursements.
(b) Balance sheets.
(c) Statements of profit and loss.

Prepare these statements and indicate what responsibility the public accountant should assume.

The statements are to be based upon estimates and assumptions furnished by the manufacturer as listed below.

1. It is proposed that the corporation will begin business on July 1, 1940, with a cash capital of $100,000, all paid in.
2. Knitting machinery consisting of eight units costing $170,000 will be ordered at once; delivery will require one month; and payment will be made as follows:
   10% in cash with order
   10% in cash on delivery
   80% by notes dated August 1, 1940, maturing quarterly in equal amounts over two years, the first note falling due at the end of the 1st quarter of 1941. Interest at 6% will be paid quarterly on unpaid notes.
3. Auxiliary machinery will cost $8,000; factory furniture, fixtures, etc., will cost $2,000; both items will be purchased at once for cash.
4. Borrowings in units of $25,000 each, 6% interest (payable at the end of each quarter), will be made as required at the beginning of quarters; repayment of not less than $25,000 each will be made when possible at the end of quarters. Cash balances must be budgeted never to be less than $20,000.
5. Quarterly production of hosiery will be as follows:

4th quarter of 1940	4,000 dozen
1st quarter of 1941	6,000 dozen
Quarterly thereafter	24,000 dozen

6. Costs of production will be as follows:
   Direct costs per dozen pairs of hosiery produced

Thrown silk (purchased on terms of 90 days net)	$ 3
Direct labor, dyeing, etc.	2

   Factory overhead, by quarters:

Starting at once	2,000
4th quarter of 1940	4,000
1st quarter of 1941	9,000
Quarterly thereafter	15,000

   Depreciation of fixed assets at a composite rate of 8% per annum will be provided starting with the 4th quarter of 1940.
7. Selling expenses will be $20,000 each quarter, starting at once.
8. General and administrative expenses by quarters will be as follows:

Starting at once	$ 3,000
4th quarter of 1940	5,000
Quarterly thereafter	6,000

9. Hosiery manufactured will be sold at the following prices:

80% firsts at	$12.00 per dozen
20% seconds at	2.00 per dozen

With every four dozen firsts, one dozen seconds will be sold.

10. Customers' terms will be thirty days net. It will be assumed that payments will be received when due, that there will be no bad debts, and that each month's sales will equal one third of the quarter's sales.

11. Inventories of thrown silk will be one half of the consumption in the succeeding quarter.

12. Inventories of finished hosiery (it will be assumed that hosiery in process will be finished at the ends of quarters) will be as follows:

End of 4th quarter of 1940	1,000 dozen
End of 1st quarter of 1941	1,000 dozen
End of each quarter thereafter	4,000 dozen

13. Inventory valuation of finished hosiery will be based upon cost at maximum production.

14. Provision for Federal income taxes will be made only at the close of the calendar years, and will not be considered in the preparation of the projected statements.

Solution to Problem 1:

A.B.C. Partnership

Statement of Capital Accounts
December 31, 1938

	A	*B*	*C*	*Total*
Balance, December 31, 1938 (before closing)	$ 60,000.00	$ 1,000.00*	$10,000.00	$ 69,000.00
Drawing account	10,000.00	7,000.00	5,000.00	22,000.00
Interest on average balance	3,600.00	120.00	280.00	4,000.00
Distribution of balance of profit	29,400.00	14,700.00	4,900.00	49,000.00
Balance, December 31, 1938 (after closing)	$103,000.00	$20,820.00	$20,180.00	$144,000.00
Cash distributed	61,360.00	—	13,240.00	74,600.00
Balance, December 31, 1938	$ 41,640.00	$20,820.00	$ 6,940.00	$ 69,400.00

* Red.

COMMENT

Since none of the partners is to pay in any cash, the capital after cash distributions will be B's capital of $20,820.00 divided by .3, or $69,400.00.

Solution to Problem 2:

Acme Carburetor Company and Subsidiary

Work Sheet—December 31, 1938

Assets	Acme Carburetor Company	Airex Manufacturing Company	Adjustments Debit	Adjustments Credit	Eliminations	Consolidated
Cash	$ 75,000.00	$ 50,000.00				$ 125,000.00
Accounts receivable	150,000.00	100,000.00				250,000.00
Accounts receivable—intercompany		25,000.00			(7)$ 25,000.00	
Inventory	270,000.00	145,000.00				415,000.00
Land	150,000.00					150,000.00
Buildings	350,000.00					350,000.00
Machinery and equipment	700,000.00	700,000.00		(1)$200,000.00		1,200,000.00
Investment in Airex Co. stock	400,000.00		(5)$ 60,240.00		(6) 460,240.00	
Deferred charges	10,000.00	5,000.00				15,000.00
	$2,105,000.00	$1,025,000.00			$485,240.00	$2,505,000.00

Liabilities						
Reserve for depreciation	$ 366,500.00	$ 256,000.00	(2) 16,000.00			$ 606,500.00
Accounts payable	75,000.00	31,000.00				106,000.00
Accounts payable—intercompany	25,000.00				(7)$ 25,000.00	
Capital stock:						
Common stock—Acme Company	750,000.00					750,000.00
Common stock—Airex Company		10,000.00			(6) 8,000.00	2,000.00 M
Preferred stock—Airex Company		100,000.00			(6) 100,000.00	
Earned surplus:						
Acme Company	700,000.00					700,000.00 S
Airex Company		559,000.00	(1) 200,000.00	(3) 6,000.00	(6) 292,000.00	73,000.00 M
Net income:						
Acme Company	188,500.00		(3) 6,000.00	(5) 60,240.00		242,740.00 S 15,800.00 M
Airex Company		69,000.00	(4) 11,200.00	(2) 16,000.00	(6) 60,240.00	2,240.00* M
	$2,105,000.00	$1,025,000.00				
Reserve for intercompany profits in inventory				(4) 11,200.00		11,200.00
					$485,240.00	$2,505,000.00
Sales	$1,500,000.00	$ 850,000.00			$350,000.00	$2,000,000.00
Other income	10,000.00		((3)$ 6,000.00)			4,000.00
Total	$1,510,000.00	$ 850,000.00			$350,000.00	$2,004,000.00
Cost of Sales	$1,221,500.00	$ 731,000.00	((4) 11,200.00)	((2)$ 16,000.00)	$350,000.00	$1,597,700.00
Selling and General expenses	100,000.00	50,000.00				150,000.00
Total	$1,321,500.00	$ 781,000.00			$350,000.00	$1,747,700.00
Net income of parent company and minority	$ 188,500.00	$ 69,000.00				$ 256,300.00
Minority interest:						
Minority interest in adjusted profits of Airex Company (20% of $79,000.00)						$ 15,800.00
Profit in inventory of Acme Company (20% of $11,200.00)						2,240.00
						$ 13,560.00
Consolidated net income			$ 293,440.00	$ 293,440.00		$ 242,740.00

* Red.

Key

1. To write off machinery and equipment in accordance with the appraisal made as of January 1, 1938.
2. To adjust depreciation charge and the reserve for depreciation charged on values written off in (1) above.
3. To adjust surplus and net income accounts for dividends on Airex preferred stock.
4. To adjust the net income of the Airex Company for unrealized profit on sales to the Acme Company:

Sales of Airex Company		$850,000.00	100%
Cost of Sales:			
Material	$400,000.00		
Factory labor	125,000.00		
Manufacturing expense	206,000.00	731,000.00	86%
Gross profit		$119,000.00	14%

The adjustment is 14% of $80,000.00, or $11,200.00.

5. To pick up the net income of the Airex Company applicable to the Acme Company:

Net income of Airex Company per books	$ 69,000.00
Depreciation adjustment	16,000.00
	$ 85,000.00
Intercompany profit adjustment	11,200.00
Applicable to preferred and common	$ 73,800.00
Distribution to Acme Company:	
Preferred stock	$ 6,000.00
Common stock 80% of ($73,800.00 less $6,000.00)	54,240.00
	$ 60,240.00

6. To eliminate the entire book value of the preferred stock and 80% of the book value of the common stock.
7. To eliminate intercompany accounts.

COMMENTS

1. During the year 1938, the Airex Manufacturing Company charged depreciation on machinery and equipment on the basis of a valuation of $700,000.00, or $56,000.00. The depreciation charge based on the appraised value would have been $40,000.00 This difference of $16,000.00 was credited to cost of sales in adjusting entry 2, because no information is given to enable one to calculate the portion applicable to the inventory on hand.

2. In adjusting the inventory of the Acme Carburetor Company for intercompany profit, the amount eliminated was that which reduced the inventory purchased from Airex to the cost of those goods to that company. Since no consideration was given in adjusting entry 2 to the

effect of the appraisal on the Airex inventory it was felt that consistency would demand similar treatment of the Acme inventory purchased from Airex.

Solution to Problem 3:

SKIHIGH LIQUOR COMPANY

Balance Sheet
September 15, 1939

Assets

Current assets			
Cash in bank		$ 500.00	
Petty cash		100.00	
Accounts receivable not assigned (Note 1)		7,609.66	
Notes receivable		190.00	
Inventories (Note 2)			
Spirits	$1,530.00		
Wines	360.00		
Beers	150.00	2,040.00	$10,439.66
Insurance, taxes and rent prepaid to September 30, 1939			1,866.66
Assets assigned			
Accounts receivable assigned to secure account payable of $11,000.50 (Note 1)		$12,000.50	
Inventories held in bonded warehouse to secure account payable of $10,006.54		10,006.54	22,007.04
Other assets (Note 3)			
Advances to salesmen		$ 6,000.00	
Note receivable, officer		300.00	
		$ 6,300.00	
Less reserve for doubtful accounts		6,300.00	nil
Total			$34,313.36

Liabilities

Current liabilities		
Accounts payable, unsecured	$34,093.86	
Accounts payable, secured by inventory held in bonded warehouse and assignment of accounts receivable	21,007.04	
Note payable, president	2,000.00	
Accrued sales taxes	900.12	$58,001.02
Capital stock and deficit		
Capital stock	$10,000.00	
Deficit (Note 4)	33,687.66	23,687.66
Total		$34,313.36

Note 1. No provision has been made for possible losses on accounts receivable.

Note 2. Book inventories on September 15, 1939, were overstated by $1,875.00. Inventories shown in the balance sheet were determined as follows:

	Cases on hand 9/30/39	Cases sold 9/15/39 to 9/30/39	Cases on hand 9/15/39	Cost per case	Amount
Old Mahogany Rye	40	10	50	$24.00	$1,200.00
Filibuster Special Bourbon	10	5	15	18.00	270.00
Old Bluebottle	5	5	10	6.00	60.00
Total spirits					$1,530.00
Sparkling Muscatel	20	10	30	12.00	360.00
Beers	60	40	100	1.50	150.00
Total inventory					$2,040.00

Note 3. A reserve of 100% has been provided against the advances to salesmen and the note receivable from an officer.

Note 4.

Deficit per books		$21,512.66
Add: Inventory shortage	$1,875.00	
Provision for loss on advances to salesmen and loan to officer	6,300.00	
Life insurance policy carried on the books at $4,000.00 but assigned to wife of the insured	4,000.00	12,175.00
Deficit per balance sheet		$33,687.66

Journal Entries September 15, 1939 to September 30, 1939

(1)		
Interest on bank loan	$ 100.00	
Cash in bank—regular account	5,590.00	
Cash in bank—special account	14,005.50	
Accounts receivable, not assigned		$ 2,005.00
Note receivable		190.00
Accounts receivable, assigned		12,000.50
Advances to salesmen		500.00
Bank loan		5,000.00
Cash receipts		
(2)		
Cash in bank—regular account	7,000.00	
Cash in bank—special account		7,000.00
Cash Transfer		
(3)		
Note payable, president	2,000.00	
Accounts payable	5,000.00	
Liquor license	1,000.00	
Advances to salesmen	1,000.00	
Cash in bank—regular account		9,000.00
Cash disbursements		
(4)		
Sundry expenses	100.00	
Petty cash		100.00
Petty cash disbursements		
(5)		
Accounts receivable, not assigned	690.00	
Sales		690.00
To record sales		
(6)		
Sales tax	20.70	
Accrued sales taxes		20.70
Sales taxes, 3% of $690.00 (Illinois rate)		
(7)		
Cost of sales	540.00	
Inventories:		
Spirits		360.00
Wines		120.00
Beers		60.00
To record cost of sales		
(8)		
Accounts payable, secured	$10,006.54	
Inventory in bonded warehouse		$10,006.54
To record transfer of title to inventory in warehouse in settlement of account payable.		
(9)		
Bad debts	500.00	
Reserve for doubtful accounts		500.00
To provide reserve of 100% against advances to salesmen.		

SKIHIGH LIQUOR COMPANY
Tentative Balance Sheet
September 30, 1939
Assets

Current assets		
Cash in bank (Note 1)		
Regular account	$4,090.00	
Special account	7,005.50	$11,095.50

Accounts receivable, not assigned		6,294.66	
Inventories, at cost			
Spirits	$1,170.00		
Wines	240.00		
Beers	90.00	1,500.00	
Liquor license for year ending September 30, 1940 (Note 2)		1,000.00	
Total current assets (Note 3)			$19,890.16
Other assets			
Advances to salesmen		$ 6,500.00	
Notes receivable, officer		300.00	
		$ 6,800.00	
Less reserve for doubtful accounts		6,800.00	nil
			$19,890.16

Liabilities

Preferred creditors		
Accrued sales taxes (Note 1)		$ 920.82
Secured creditors		
Bank loan (Note 1)	$ 5,000.00	
Accounts payable (Notes 1 & 3)	11,000.50	$16,000.50
Unsecured creditors		
Accounts payable (Note 4)		29,093.86
Capital stock and deficit		
Capital stock	$10,000.00	
Deficit	36,125.02*	26,125.02*
		$19,890.16

* Red.

Note 1.

Cash in bank		$11,095.50
Subject to claims as follows:		
Bank loan	$ 5,000.00	
Accrued sales taxes	920.82	
Creditor for proceeds of assigned accounts receivable	5,174.68	11,095.50
Available for unsecured creditors		nil

Note 2. The prepaid liquor license may be transferable and therefore have a realizable value. This item is shown at cost.

Note 3.

Current assets		$19,890.16
Subject to claims as follows:		
On cash (Note 1)	$11,095.50	
Lien by creditor for proceeds of assigned accounts receivable, $11,000.50 less $5,174.68	5,825.82	16,921.32
Available for unsecured creditors and costs		$ 2,968.84

Note 4.

Unsecured creditors	$29,093.86
Less amount available for unsecured creditors (Note 3)	2,968.84
Deficiency to creditors	$26,125.02

OTHER COMMENTS

1. Perhaps some portion of the $100.00 deducted by the bank as interest may be recoverable.
2. Payments to creditors and to the president may be regarded as preferential payments and therefore, recoverable for the benefit of all creditors.
3. The assignment of the life-insurance policy to the wife of the president should be investigated.
4. On the balance sheet at September

15, 1939 the inventory in bonded warehouse was regarded as security for the account payable. If this is not the correct situation then the transfer of title to this inventory may be set aside as a preferential payment.

Solution to Problem 4:

WORK SHEET

Raw Materials

	Purchases		Inventory at End of Quarter		Used in Production	
	Units	*Amount**	*Units*	*Amount*	*Units*	*Amount*
1940—3rd.......	2,000	$ 6,000.00	2,000	$ 6,000.00		
4th.......	5,000	15,000.00	3,000	9,000.00	4,000	12,000.00
1941—1st.......	15,000	45,000.00	12,000	36,000.00	6,000	18,000.00
2nd.......	24,000	72,000.00	12,000	36,000.00	24,000	72,000.00
3rd.......	24,000	72,000.00	12,000	36,000.00	24,000	72,000.00

* All paid in subsequent quarter.

Finished Goods

	Material Used	Direct Labor	Factory Overhead*	Total	Less Overhead in Excess of Normal	Balance	Per Cent of Production in Inventory	Inventory of Finished Goods	Cost of Goods Sold
1940—3rd....			$ 2,000.00	$ 2,000.00	$2,000.00				$ 2,000.00
4th...	12,000.00	$ 8,000.00	7,600.00	27,600.00	4,500.00	$ 23,100.00	25%	$ 5,775.00	21,825.00
1941—1st...	18,000.00	12,000.00	12,600.00	42,600.00	7,950.00	34,650.00	16⅔	5,775.00	42,600.00
2nd...	72,000.00	48,000.00	18,600.00	138,600.00		138,600.00	16⅔	23,100.00	121,275.00
3rd...	72,000.00	48,000.00	18,600.00	138,600.00		138,600.00	16⅔	23,100.00	138,600.00

* Includes depreciation of $3,600.00 per quarter, commencing with the 4th quarter of 1940.

	Sales		Collections		
	Units	Amount	Same Quarter as Sale	Following Quarter	Total
1940—3rd....					
4th....	3,000	$ 30,000.00	$ 20,000.00	$10,000.00	$ 20,000.00
1941—1st....	6,000	60,000.00	40,000.00	20,000.00	50,000.00
2nd....	21,000	210,000.00	140,000.00	70,000.00	160,000.00
3rd....	24,000	240,000.00	160,000.00	80,000.00	230,000.00

HOSIERY MANUFACTURING COMPANY

Statements of Estimated Profit and Loss by Three Month Periods
July 1, 1940 to September 30, 1941
(*These statements are based upon estimates furnished by the management.*)

	Three Months Ended				
	9/30/40	12/31/40	3/31/41	6/30/41	9/30/41
Gross Sales..........................	—	$30,000.00	$60,000.00	$210,000.00	$240,000.00
Cost of Sales					
Finished goods inventory at beginning of period........................	—	—	$ 5,775.00	$ 5,775.00	$ 23,100.00
Cost of goods manufactured:					
Raw material purchased...........	$ 6,000.00	$15,000.00	45,000.00	72,000.00	72,000.00
Raw material inventory variation...	6,000.00*	3,000.00*	27,000.00*	—	—
Direct labor.....................	—	8,000.00	12,000.00	48,000.00	48,000.00
Overhead.........................	2,000.00	4,000.00	9,000.00	15,000.00	15,000.00
Depreciation.....................	—	3,600.00	3,600.00	3,600.00	3,600.00
Finished goods inventory end of period	—	5,775.00*	5,775.00*	23,100.00*	23,100.00*
Total cost of sales................	$ 2,000.00	$21,825.00	$42,600.00	$121,275.00	$138,600.00
Gross profit on sales...............	$ 2,000.00*	$ 8,175.00	$17,400.00	$ 88,725.00	$101,400.00
Selling Expenses.....................	20,000.00	20,000.00	20,000.00	20,000.00	20,000.00
Net profit on sales.................	$22,000.00*	$11,825.00*	$ 2,600.00*	$ 68,725.00	$ 81,400.00
General Expenses.....................	3,000.00	5,000.00	6,000.00	6,000.00	6,000.00
Net profit on operations............	$25,000.00*	$16,825.00*	$ 8,600.00*	$ 62,725.00	$ 75,400.00

Interest Expense					
Bank loan	—	$ 375.00	$ 750.00	$ 750.00	$ 750.00
Serial note	$ 1,360.00	2,040.00	2,040.00	1,785.00	1,530.00
Total	$ 1,360.00	$ 2,415.00	$ 2,790.00	$ 2,535.00	$ 2,280.00
Net Profit	$26,360.00*	$19,240.00*	$11,390.00*	$ 60,190.00	$ 73,120.00

* Red.

Hosiery Manufacturing Company

Estimated Cash Statement
July 1, 1940 to September 30, 1941
(*These statements are based upon estimates furnished by the management.*)

	1940		1941			
	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	Total
Balance beginning of period	—	$29,640.00	$ 29,225.00	$ 22,435.00	$ 28,900.00	—
Receipts						
Capital paid in	$100,000.00	—	—	—	—	$100,000.00
Bank loans	—	25,000.00	25,000.00	—	—	50,000.00
Sales	—	20,000.00	50,000.00	160,000.00	230,000.00	460,000.00
Total receipts	$100,000.00	$74,640.00	$104,225.00	$182,435.00	$258,900.00	$610,000.00
Disbursements						
Purchase of knitting machinery	$ 34,000.00	—	—	—	—	$ 34,000.00
Payment of notes issued for 80% of cost of knitting machinery	—	—	$ 17,000.00	$ 17,000.00	$ 17,000.00	51,000.00
Interest on above notes	1,360.00	$ 2,040.00	2,040.00	1,785.00	1,530.00	8,755.00
Auxiliary machinery & furniture	10,000.00	—	—	—	—	10,000.00
Material	—	6,000.00	15,000.00	45,000.00	72,000.00	138,000.00
Direct labor	—	8,000.00	12,000.00	48,000.00	48,000.00	116,000.00
Overhead	2,000.00	4,000.00	9,000.00	15,000.00	15,000.00	45,000.00
Selling expenses	20,000.00	20,000.00	20,000.00	20,000.00	20,000.00	100,000.00
General expenses	3,000.00	5,000.00	6,000.00	6,000.00	6,000.00	26,000.00
Interest on bank loan	—	375.00	750.00	750.00	750.00	2,625.00
Payment of bank loans	—	—	—	—	50,000.00	50,000.00
Total disbursements	$ 70,360.00	$45,415.00	$ 81,790.00	$153,535.00	$230,280.00	$581,380.00
Balance at end of period	$ 29,640.00	$29,225.00	$ 22,435.00	$ 28,900.00	$ 28,620.00	$ 28,620.00

Hosiery Manufacturing Company

Estimated Quarterly Balance Sheets
September 30, 1940 to September 30, 1941
(*These statements are based upon estimates furnished by the management.*)

	1940		1941		
Assets	*September 30*	*December 31*	*March 31*	*June 30*	*September 30*
Current assets					
Cash	$ 29,640.00	$ 29,225.00	$ 22,435.00	$ 28,900.00	$ 28,620.00
Accounts receivable	—	10,000.00	20,000.00	70,000.00	80,000.00
Inventory:					
Raw material	6,000.00	9,000.00	36,000.00	36,000.00	36,000.00
Finished goods	—	5,775.00	5,775.00	23,100.00	23,100.00
Fixed assets					
Machinery and fixtures	180,000.00	180,000.00	180,000.00	180,000.00	180,000.00
Less—Reserve for depreciation	—	3,600.00*	7,200.00*	10,800.00*	14,400.00*
	$215,640.00	$230,400.00	$257,010.00	$327,200.00	$333,320.00

Liabilities					
Current liabilities					
Accounts payable................	$ 6,000.00	$ 15,000.00	$ 45,000.00	$ 72,000.00	$ 72,000.00
Bank loans....................	—	25,000.00	50,000.00	50,000.00	—
Serial notes payable (due $17,000 each quarter beginning 3/31/40).......	136,000.00	136,000.00	119,000.00	102,000.00	85,000.00
Net worth					
Capital stock..................	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Surplus:					
Balance beginning of period.....	—	26,360.00*	45,600.00*	56,990.00*	3,200.00
Current profit or loss*..........	26,360.00*	19,240.00*	11,390.00*	60,190.00	73,120.00
	$215,640.00	$230,400.00	$257,010.00	$327,200.00	$333,320.00

* Red.

The public accountant's responsibility should be limited to the mathematical accuracy of the statements. The figures presented are based upon estimates of future events and the heading of each statement should indicate this fact.

GENERAL COMMENTS

Here is a set of problems which, while far from an ideal C.P.A. examination, is superior to Part I of the same examination, which appeared in the December issue of the REVIEW. Unlike problem 3 of part 1, the problems of this set are clearly stated and lead to a solution without imposing on the candidate the added burden of reading the mind of the examiner.

Problem 1 is very simple and should bring a perfect score to everyone taking the examination. Problem 2 is a good problem and, while not difficult, will require of the examinee a fair knowledge of the principles of consolidation. Problem 3 is an easy problem and is given a weight (30 points) far in excess of its value. Problem 4 is the best problem in the examination. Although no difficult points of accounting theory are presented, it should serve to show the ability of the candidate to organize his work—an ability which one should have before being called an accountant.

Problem 4 is likely to trap many candidates in an error which experience has shown is all too common in those aspiring to the C.P.A. degree. In their desire to complete a problem in the shortest possible time, too many candidates take pencil in hand too soon, only to find themselves making one false start after another. Greatest speed will be attained if a skeleton solution is definitely outlined in the mind of the candidate before he starts to write. Easily pictured is the panic of the "too-quick-on-the-pencil" candidate caught in the maze of problem 4.

The following time schedule may be helpful to those who wish to solve these problems:

Problem 1	20 minutes
Problem 2	90 minutes
Problem 3	90 minutes
Problem 4	120 minutes

The Accounting Review

THEORIES & PRACTICE

FEDERAL ACCOUNTING

A number of papers in this issue of the REVIEW, dealing with Federal accounting and auditing, have been prepared by persons familiar with practices now being followed and are both descriptive and critical in character. These papers will furnish a background for accountants who desire to know something about Federal accounting procedures, and it is hoped that they may in some degree crystalize the broad criticisms which have frequently been leveled at theories of Federal fiscal responsibility: many of which have been inherited from the days of Alexander Hamilton.

One of the most important features of the Reorganization Bill of 1937 which met defeat in Congress was the reform of Federal accounting and audit procedures, the details of which are discussed in these papers. Accounting and auditing traditions of the Federal government were praised or excoriated by political leaders, often without any knowledge of the nature or effects of current practices. In the end, nothing was done, and although some voluntary improvements in departmental and Treasury practices may be enumerated, Federal accounting today stands at a low level, unmatched anywhere in private business.

The Budget and Accounting Act of 1921 placed the responsibility for the accounting systems of the government in the hands of a Comptroller General who as head of a "General Accounting Office" was made independent of current administrations. But Congress neglected to provide adequate machinery to control the activities of the Comptroller. When the first Comptroller General's 15-year term expired in 1936, he left nothing that would be recognized by a public accountant as an accounting organization. Practically none of his staff of 5,000 were accountants, and with one or two exceptions, although charged with the audit of nearly all Federal accounts, he had issued no audit reports. In his annual reports to Congress, many of which, especially in recent years, have been in typewritten form and therefore unavailable to the public, he complained bitterly about lack of coöperation from executive agencies and asked for more powers. His statements concerning individual Federal departments and agencies were unsupported by financial statements; for the most part they were loosely, even ungrammatically phrased, and notoriously inaccurate. It is probably safe to say that no member of Congress ever read his reports, or knew what course of action to pursue if he read sections of them.

A leading problem is the distinction that has been urged between preaudit and postaudit. Nearly all agree that to obtain responsibility from an administrator he must be held accountable for expenditures without interference from outsiders who can substitute their judgment for his. If outsiders have the right to prevent the making of an expenditure, the responsibility—and hence the administration—is immediately divided; and if anything goes wrong, no one is to blame. The need for this distinction does not always seem clear to public accountants, although the separation is always observed in private enterprise where "preaudit" becomes "internal control" and "postaudit" becomes "an-

nual audit." Some members of Congress believe that the Comptroller General should be given the full power of preaudit, a power he does not now possess.

Under existing law, it may be worth noting that the person accountable for expenditures of Federal departments is not even the administrator but the lowly "disbursing officer," an employee of the administrator charged with the duty of paying obligations incurred by others. It is difficult for the uninitiated to understand how such grotesque practices can continue to exist.

Reporting by the Federal government has been seriously neglected. All the Federal departments and agencies issue annual reports but only the financial statements of Federal corporations are brought together by the Treasury Department and consolidated.

INSTITUTE RESEARCH

The following letter has been received from the Vice-Chairman of the Committee on Accounting Procedure of the American Institute of Accountants:

"To the Editor of the ACCOUNTING REVIEW:
"Dear Sir:

"May I ask the opportunity to put before your readers a few points in relation to the bulletins issued by the Committee on Accounting Procedure of the American Institute of Accountants which were the subject of comment in the editorial columns of your December issue?

"I do not propose to discuss those comments in detail. Of course, the question asked on page 455—whether the Committee, when it speaks of 'this argument,' means a particular argument or all argument—does not call for an answer; it merely indicates that the questioner's critical faculty is jaded. And the danger of treating the cost of removing a structure (whether financial or physical) which a corporation has created, as a part of the cost of the structure which replaces it, is surely as obvious as it is real. In the interests of accuracy I should add that in Bulletin No. 1 the Committee did not reissue seven rules 'with approval,' but 'in order that the record may be complete.'

"However, my main purpose in writing is to emphasize the fact that the Committee does not regard its bulletins as the last word on the subjects with which they deal, but welcomes constructive comments, criticisms or suggestions after as well as before publication. Readers of *The Journal of Accountancy* will be kept advised of matters under consideration by the Committee and will be afforded ample time to express their views before pronouncements are made, except, of course, where emergency action becomes necessary.

"May I also say that at its meeting on November 21, 1939, the Committee adopted a procedure looking to the presentation of the reasons for dissent in cases in which members of the Committee disagree with an opinion. In the case of Bulletin No. 1, the two dissents were based on exactly opposite reasons, Professor Kester disapproving of the Committee's failure to recognize the third method (spreading the discount and redemption premium over the life of the new issue), while Professor Paton held that only the immediate writing off should be approved.

"I would also invite the particular attention of your readers to the statement of the Committee's general approach to problems as set forth in Bulletin No. 1. It will be helpful to the Committee to know how far this approach meets the views of accountants engaged in either practice or education.

"Yours very truly,
"George O. May."

The REVIEW is glad to have this expression of opinion by Mr. May concerning his committee's activities. The strong implication in the first "bulletin" was that the Committee intended to give to its "pronouncements" a finality that would establish rules for the profession to follow; particularly is this inference strong in the paragraph relating to their "retroactive effect." It is hoped that in the future the Committee will give greater emphasis to the tentative character of its findings, invite discussion, and abandon the notion which runs strongly in Bulletin No. 1 that it is attempting to dictate accounting practices.

For Mr. May's benefit let it be said that the question on page 455 to which he refers was purely rhetorical; to call the ques-

tioner's critical faculty "jaded" does not answer the criticism of labeling as "fraught with danger" an argument to which no adequate response has been made either by the Committee or by Mr. May. But it now appears that it was not really to the act of arguing that the danger symbol was sought to be attached but to the treatment of "the cost of removing a structure . . . as a part of the cost of the structure which replaces it. . . . "

Translated into the subject-matter of Bulletin No. 2, Mr. May's words might read thus: (the cost) unamortized discount (of removing a structure) on a refunded bond issue ([is not] a part of) is not a part of (the cost of) the discount attributable to (the structure which replaces it) the refunding issue. Put in these plain terms, and made cognate with the rest of the bulletin, the argument meets with difficulty. Upon the premature discharge of a debt "other than by refunding," says the Committee, the unamortized discount "should be written off": an inference that the refunding operation carries with it the right to bring forward the residual discount. But, says Mr. May, the cost of removing (the unamortized discount) does not attach to the new structure (the refunding issue). Without a successor issue it must be eliminated; but with a successor issue, it may be retained, although not as a part of the cost of such issue.

When it comes to framing a reason for the Committee's preference—to continue the amortization-expense charge as though the refunded issue continued to exist—the Committee says that the remaining discount and any retirement premium can be regarded as "the price of an option to refund the [original] issue if and when refunding seems *profitable*." Yet this tortured analogy applies with even greater force to a redemption, not accompanied by a refunding, made possible from funds provided by stored-up profits or reserves; for not only is a part of the interest saved, but all of it. Why, then, shouldn't the discount and premium on any bonds retired before maturity be spread over their original life, since so profitable a saving for that period has been effected? The omission by the Committee of any argument on this point seriously weakens the significance of the position it has taken.

Mr. May suggests that there are similarities between physical and financial structures. Would he approve carrying forward and amortizing over its original useful life the cost of dismantling an old plant which is replaced by a new, more cheaply operated structure, where the realization of inefficiency in the old plant and the building of the new are events occurring within a single year?

On the other hand it may be argued (possibly by Professor Kester) that the refunding issue is not a new structure but a mere revamping of the old: a new roof that will reduce maintenance costs and extend life—an expenditure that will more than pay for itself. Similarity in the handling of assets and liabilities is desirable; but the comparison does not demand an interpretation confined to a single case.

Can it be that *both* Professors Kester and Paton are right?

Perhaps the suggested rule of amortization over the life of the old issue is more of an expedient than a rule founded securely on good theory. Some corporations, had the immediate-charge-off rule been forced upon them, would have faced the extinction of their common-stock equities, to say nothing of the source of next year's preferred dividends.

CASES IN ACCOUNTING

On page 103 of this issue a new department has been inaugurated for readers of the REVIEW. It will present in each issue a number of practical situations illustrating ac-

counting procedures of current importance and takes the place of "Accounting and the SEC"—a series of cases for REVIEW readers appearing in 1937 and 1938 issues. However, the new department, although for the present limited to material obtained from the public files of the Securities and Exchange Commission, will ultimately not be confined to the problems of that body. It is hoped that material from various sources will be available, and readers are asked to contribute case material which they believe will interest practitioners and students of accounting.

Professor Allan J. Fisher of the University of Maryland will head this department during the current year and has agreed to supply several SEC cases which he believes have more-than-ordinary value to accountants. In presenting the material for each case the objects have been: (a) to describe one or more problems in which accounting interpretations and judgments have been involved; (b) to furnish enough background material to enable the reader to grasp the setting and the practical significance of the problems. From the frank presentation and discussion of these situations it is hoped that both practitioners and students will profit. Accounting instructors should find in the points presented ample material for classroom discussions.

E. L. KOHLER

BOOK REVIEWS

Trends in Rural Retailing in Illinois 1926 to 1938. Robert V. Mitchell. (Urbana: University of Illinois, Bureau of Business Research, 1939. Pp. 63.)

This study which appears as Bulletin No. 59 of the Bureau of Business Research of the University of Illinois, shows that the sales of village merchants in Illinois have decreased from 1926 to 1938 by more than the decline in the price level. It also shows that these merchants have greater than average bad-debt losses.

The study included merchants in 72 towns in two districts in Illinois, each with a population of 2,500 or less. In addition to the interview with merchants, opinions were received from postmasters, bankers, and newspaper editors in regard to business conditions in their communities.

Relatively more dealers in small villages lost trade since 1926 than in larger ones. Stores located farther from primary trading centers held their own better from 1926 to 1938 than those nearer such centers. In 1938, however, those within 10 miles of a center seemed to be faring as well as those over 20 miles away, with the intermediate group from 10 to 19 miles away suffering most.

Chain food stores and implement dealers made the best showing for the twelve-year period. Chain food stores and furniture stores showed the greatest stability in individual sales, but with furniture stores losing in number of stores. Drug stores, general stores, and automobile agencies suffered more than the other kinds of business. Lumber dealers and hardware stores also were below average. Independent food stores, dry goods stores, and clothing stores made a somewhat better showing in individual sales, but with the number of dry goods and apparel stores showing a greater decrease than that of any other types.

In the opinion of village merchants, the most important factor causing a decline in sales volume since 1926 was the increased use of automobiles and improved roads. Other important causes given were agricultural depression, depression psychology, and chains in primary trading centers. Many individual merchants had successful operations, however, suggesting that the efficiency of the merchants may have been one of the most important factors in success or failure.

The study of credit revealed that although the village merchants have tightened up their credit terms, their stores are still characteristically credit stores whose bad-debt losses are heavy. Forty-six and two tenths percent of the stores did over a third of their business on credit. Most of the dealers asserted that their losses had been small, but they had no idea of the amount. The figures that were obtained indicated that the bad-debt losses of the village merchants had been heavy. Only 20.1% had losses that amounted to .5% or less, while 25.6% had losses of 5% or more.

The majority of merchants said they had no definite method of granting credit or collecting. Only 12.5% sent statements regularly. The stores that set definite credit limits for each account or sent statements to customers regularly had the lowest bad-debt losses.

Although Mr. Mitchell's conclusions are probably correct, his figures do not prove that trade is being pulled away from the villages to the larger centers. Since his reports were by numbers of dealers rather than volume of sales, it is conceivable that the 64.6% who, from 1926 to 1938, lost dollar volume by more than the decline in general prices, merely lost that trade to the 13.1% who reported gains, or to the 103 dealers who were not included because they had entered business during the period. That these new dealers were gaining is indicated by the fact that in the 1938 estimate in which they were included, only 33.7% felt that they were losing trade and 26.8% reported gains. Or, possibly filling stations, accessory, tire, and battery stores, which were not included, got the business. It would have been interesting to have had these stores included, and to have had a similar study in the trading centers themselves.

E. R. Hawkins

University of Pennsylvania

Turning Points in Business Cycles. Leonard P. Ayres. (New York: The Macmillan Company, 1939. Pp. xiii, 214. $2.75.)

The central thesis of this book is that downturns in business cycles occur when conditions become unfavorable for securing new business capital or replacing old capital through the sale of bonds, notes, and stocks, and that cyclical upturns take place when conditions for new capital flotations become favorable again. Lying behind the fluctuations in capital flotations is a monetary mechanism which brings about changes in short-term interest rates. Changes in these rates induce cyclical changes in bond prices and in stock prices, which in turn induce the fluctuations of capital flotations. Most of the book is devoted to a demonstration that such a sequence of developments has taken place with a high degree of consistency throughout the history of American business cycles: that is, prior to a cyclical downturn of business there has been first an upturn in short-term interest rates, followed by a downturn of bond prices, of stock prices, and of capital flotations in that order; and prior to cyclical upturns of business there has been the same sequence with the direction of movements reversed.

The demonstration covers 26 business cycles, beginning in 1831 and ending in 1939. For the most part statistical data already derived by others has been utilized, but a contribution of new data has been made by compiling a series from the listings of new corporate securities on the New York Stock Exchange for some 40 years prior to 1906, the earliest date covered by previously available series in this area.

The author frankly recognizes that the business cycles of the last 25 years have differed in important respects from prewar cycles. Although the same sequences have in general prevailed, the importance of security issues and monetary conditions as causes of

cyclical fluctuations in business has diminished. The more flexible control of the Federal Reserve authorities has been substituted for the comparatively rigid operation of the reserve requirements of the banks during the years prior to the establishment of the Federal Reserve system. Moreover, the spending of the Federal government has become an important factor in addition to the raising of funds by private business.

The material in the book is well presented. Numerous charts illuminate the text. Statistical data has been utilized with discretion. Weaknesses in the data have been pointed out. There is no claim that a reliable forecasting system has been developed even though the sequences demonstrated can aid in the interpretation of current fluctuations of business. On the whole the book will contribute to a better understanding of business cycles despite the fact that, for the most part, it does not present a new thesis or new material.

J. L. Snider

Harvard University
Graduate School of Business Administration

Accounting Research Bulletins, Nos. 1, 2, 3, 4. Issued by the Committee on Accounting Procedure of the American Institute of Accountants. (New York: 1939. Pp. 36.)

The research bulletins referred to represent the first in a series of special studies concerning matters of accounting procedure. Accounting has now reached a certain stage in its development which makes it imperative that these studies be undertaken. The development of the modern corporation and the many accounting problems it has presented to the profession, together with the very marked growth in membership of the profession itself, have combined to produce a heterogeneous body of principles and practices. Unfortunately, principles and practice are not always in agreement, and while a certain amount of dissent is necessary for healthy growth in any undertaking, the time is ripe for a certain amount of codification.

In attempting to review these bulletins, a certain difficulty presents itself. For example, the committee in charge of these studies unanimously, and it seems to this reviewer, somewhat magnanimously, resolved that its pronouncements were not retroactive. If a certain amount of skepticism has crept into the last statement, it is no more than the average accountant would feel on reading it. In other words, it has become a question of how far the American Institute of Accountants represents the profession as a whole, and how far its pronouncements can be made binding. The point, therefore, is not so much whether the Institute through its committee waives the question of retroactivity as how far it can go in enforcing its dicta. To be sure, the committee is a well rounded one, being composed of eminently able representatives of some of the best accounting firms, and including also many learned members taken from the academic field. It is to be supposed, therefore, that any pronouncements emanating from such a body would carry with it a considerable amount of weight *if the rules laid down will not deviate too drastically from what has come to be accepted practice.*

As a practical proposition, the influence of the Institute must be measured against other forces actively at work. On the one hand there is the American Accounting Association, which on a less ambitious scale has undertaken a number of studies which have every right to be considered as official pronouncements with the weight of educational authority behind them. Further than that, we have the work of the SEC, and while we do not like to see a governmental authority lay down rules of accounting practices and procedure, the fact of the matter is that the SEC has performed just that function, and, on the whole, has done it very well. Should, therefore, conflicts arise as between the SEC, the American Accounting Association, the American Institute, not to mention the state societies and the various regulatory bodies, it is hard to see just who is going to come out ahead. The most, therefore, that can be said for these research studies is that, if they are well grounded, they may cause accounting thought to be focused on these problems in the hope that further discussion will result in a more uniform acceptance of these practices than prevails at present.

Bulletin No. 1 contains a general introduction reciting the social aspects of corporation accounting, with particular emphasis on the position of the security holder, and a further emphasis, reiterated several times, that the statement of income is now to be considered of major importance, with the balance sheet assuming the role of a "connecting link between successive income statements and as a vehicle for the distribution of charges and credits between them" (p. 2). The committee has based its work on a series of rules adopted by the Institute in 1933 and 1934, and also on a report issued in 1938 dealing with profits and losses on treasury stock.

Of the four bulletins, No. 2, dealing with the unamortized discount and redemption premium on bonds refunded seems to be the most important. It seems also to be the most controversial of the bulletins. The statement was adopted by sixteen affirmative votes, four votes not recorded, and two dissenting votes. The dissenters in this case are important. Professors Paton and Kester are the dissenters in question; in view of the reputation of these two men in the accounting field, it is suggested that space might have been given to their expressions of dissent. As it is, the reader is left in the dark as to what could have been the basis for such dissent.

Three methods are discussed for the writing off of the unamortized discount and redemption premium. First, a direct charge to earned surplus; secondly, amortization over the remainder of the original life of the issue retired; and third, amortization over the life of the new issue. The arguments for and against these methods are well presented. Of the three methods, the first conforms closely to accepted accounting doctrines, and has the support of a Supreme Court decision. The decision referred to is Great Western Power Company of California v. the Commissioner of Internal Revenue. (297 U. S. 543). It and several others are listed in Appendix A. The second method, it is contended, is also in accord with generally accepted accounting the-

ory, though perhaps it does not conform as closely as method 1. Regarding the third method, it is the committee's contention that it "does not seem to be academically supported by accounting theory, but to run counter to generally accepted accounting rules" (p. 10). The committee seems, therefore, opposed to this particular method.

Now what actually are the principles involved? On page 14 the committee cites two rules, although it does not cite the actual sources where a formal declaration of these rules has been made. They are as follows:

a. The rule that a loss or expense should be written off not later than the time when the series of transactions giving rise to it is completed;
b. The rule that when a cost is incurred, the benefit of which may reasonably be expected to be realized over a period in the future, it should be charged against income over such period rather than against income of the period in which the amount is paid or ascertained.

To be sure, the rules represent a degree of common sense to which all accountants will subscribe. Their interpretation, however, is open to question. The whole discussion probably rests on the theory of the closed transaction. Obviously, if a bond issue is floated and subsequently redeemed, the transaction is closed. This, however, is not the uniform experience of the modern corporation. Certainly railroad bonds, no matter what their terms may be, must be considered as part of the permanent debt of a corporation. Practically the only way in which a bondholder can recover his investment is by selling it to another who is willing to assume the former's investment. Bonds are paid off at maturity by refunding them, and the question may very well be raised, therefore, whether the refunding operation closes one transaction and opens a new one, or whether it is not merely a part of a continuous process. What is true of railroads is to a large extent true of many industrials. It seems to this reviewer, therefore, that a good case can be built up for method number 3, on the principle that the transaction involved in refunding bond issues is never closed, short of liquidation of the business. If that is the case, the unamortized bond discount and redemption premium may very well be written off over the entire life of the new issue, instead of over the remaining life of the old issue. The same arguments presented against method number 3 could, therefore, have been built up to the point where that method becomes equally acceptable with the others.

The committee, therefore, finds itself in a rather awkward position. It recommends the use of methods 1 and 2 as permissible, and does not require any qualifications of the certificate when either of these methods is employed. It is forced, however, to make an exception because of the fact that various regulatory bodies have adopted method 3 as standard procedure in the cases under question. To make the confusion worse, the SEC considers it sound accounting to write off the unamortized discount "by a charge to earnings or to earned surplus in the accounting period within which the bonds were retired." (Accounting Release No. 10.) This particular decision, however, does not quite cover as broad a field as the topic under discussion.

Not only is the committee in an awkward position, but the profession of accountancy in general must find itself at a loss. So far as the SEC is concerned, its word is law in all matters falling within its jurisdiction. The same may be said of other regulatory bodies who may have taken a different stand from that advocated by the committee of the Institute. It must be the earnest hope of every accountant that the future development of the profession shall not depend primarily upon governmental regulations. Such regulation has a tendency to lay down principles from a generally biased point of view, as witness the divergence of many income tax regulations from accepted accounting principles. There is the further danger of freezing accounting thought into narrow channels through statutory or administrative action. It must, however, be conceded that at the present time there does not exist any body of men within the profession capable of asserting its authority over its practitioners. The time will come, and it is hoped soon, when only duly licensed practitioners will engage in the practice of accounting, and when it comes, some central coordinating authority may very well arise which will be capable of speaking for the profession and laying down its rules.

Bulletins 3 and 4 present nothing out of the ordinary. Number 3 deals with quasi-reorganizations or corporate readjustment; it was adopted by nineteen votes. Number 4, on foreign operations and foreign exchange, was unanimously adopted. Neither of these two bulletins contains anything very startling. In the matter of quasi reorganization or corporate readjustment, the committee recommends that it is important that the balance sheet at the time of readjustment present a fair and conservative picture. Amounts that need to be written off should be charged first against earned surplus to the full extent thereof, the balance against capital surplus. Proper precautions are to be taken in those cases where subsidiaries exist. The bulletin on foreign operations merely calls attention to the fact that in the present disturbed condition of our world economy, the usual rules for consolidating the accounts of foreign branches can no longer be held to apply. As to earnings, the committee recommends that they should be shown "only to the extent that actual remittances have been received in the United States" (p. 30). As to assets held abroad, the accountant must take into account the increasing improbability of ultimate realization by United States owners. The committee also makes recommendations as to what methods may be followed to provide adequate disclosures of information relating to foreign subsidiaries. This matter, too, has received the attention of the SEC, and is embodied in Accounting Release No. 11. There is no disagreement in principle between Accounting Release No. 11 and the statement made by the committee of the American Institute. For the sake of completeness, previous statements of the Institute covering foreign exchange have been included in the bulletin.

Whether the Institute speaks with authority or not, the time has come when someone must undertake the thankless task of codifying accounting knowledge and directing attention to those points where greater uni-

formity of procedure is desirable. The job, however, is incomplete unless the rank and file of accountants makes itself heard, and voices its criticism to the end that further clarification becomes possible.

THEODORE LANG

New York University

The Principles of Auditing. Tenth Edition. By F. R. M. de Paula, O.B.E., F.C.A. (London: Sir Isaac Pitman & Sons, Ltd. 1939. Pp. xx, 348. $3.40.)

The appearance of a tenth edition of this well-known work is of interest, both in regard to the contents of the book, and also for the position which its author has attained in the world of British accounting. As controller of finance of the Dunlop Rubber Company Limited, the 1937 published statements of which are given as Appendix A of the present volume, Mr. de Paulo has taken a place in the forefront of those British accountants who advocate more informative reports to stockholders. It is almost true to say that no extensive discussion of that subject takes place in England without some reference being made to him and his work.

This edition follows the general lines of former editions, with no changes of principle, but with a few topics more fully developed. The growing prevalence of holding companies leads the author to devote more discussion to consolidated statements. It is probable that, if he were writing at the end of 1939, he would have more to say about the conversion of the accounts of foreign subsidiaries, and their inclusion in consolidated balance sheets.

The author reiterates his stand upon the interpretation of the cost or market rule for the valuation of inventories. "Market" for him means the "net realizable value," when applied to finished goods. His basic contention is that, so long as there will be no loss upon realization, there is no occasion to reduce an inventory value from a cost basis. But though he asserts this as the essential accounting principle, he goes on to admit that policy may dictate other procedures, perhaps of a more conservative nature.

The first chapter does not in one respect do justice to its author's breadth and grasp. The paragraph heading "Main Objects of an Audit—Detection of Errors and Fraud," taken literally, would imply that Mr. de Paula is unaware of the fact that the main object of an audit is the review of company accounts by an independent and impartial accountant, and an expression of his opinion that the accounts have been properly prepared. This constructive purpose is in fact recognized in the body of said paragraph; but both for accounting students and for general readers it would be well to make this point clearer, including some change in the quoted paragraph title. The discussions which have taken place in America during the last ten years about the functions of an auditor have apparently not been reproduced in England with quite the same emphasis.

T. H. SANDERS

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The Taxation of Small Incomes: Social, Revenue and Administrative Aspects. Paul J. Strayer. (New York: The Ronald Press Company, 1939. Pp. viii, 210. $3.00.)

This book on "The Taxation of Small Incomes" should be received with a great deal of interest at this time, in view of the pressure of taxation on individuals caused by the increasing governmental needs brought about by the demands of the average citizen for more governmental activities in his behalf, and by the implications of war. The difficulty involved in explaining satisfactorily such a technical and controversial subject as the one under discussion, to those who are likely to be most affected by the broadening of the income tax base is regrettable, since there is probably general agreement with the statement made in the preface of the book that "in a democracy, each person should make up his own mind on current issues." True democracy cannot be achieved until the "common man" is imbued with social understanding, and has the will to accept the sacrifices and responsibilities as well as enjoy the benefits of such a Utopian system. Every effort by those more learned as to the facts and issues involved to bring comprehension of them to the masses in a simple, direct, and unbiased manner is to be commended.

On the whole the present author has presented a reasonably unbiased analysis of the major issues with which we are confronted when considering the taxation of small incomes. Following his introduction Mr. Strayer examines Revenue Aspects, the Theory of the Personal Exemption, the Exemption Level and the Distribution of the Tax Burden, Tax Consciousness, Administrative Aspects of the Taxation of Small Incomes, and Conclusions.

Those who believe that the tax systems of other countries are much superior to ours should have their opinions considerably changed by the author's brief historical sketch dealing with the taxation of small incomes in Great Britain, Australia, and Germany. Our form of government, complicated by the existence of many rather independent political subdivisions, causes a major difficulty in the realm of taxation.

No definite solution of the issues involved in the taxation of small incomes can be offered until the implications of indirect taxes receive further study, and the burden on each class of people is thoroughly analyzed and determined. If the income tax base is lowered before the indirect taxes are removed or reduced, the oppressing burden inflicted on some of our people will make them more antagonistic towards all fiscal measures, instead of having the desired effect of making them better citizens through the development in them of tax consciousness.

Mr. Strayer is to be congratulated for having made an excellent approach toward the solution of this important and vital subject.

ALFRED D'ALESSANDRO

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A Report of Progress. National Committee on Municipal Accounting. (Chicago, 1940. Pp. 16.)

The National Committee on Municipal Accounting has just issued Bulletin 10, *A Report of Progress*, describing its past activities and programs for the future. Ostensibly a "progress report," the bulletin is in reality an elucidation of the ideas underlying the program set up by the Committee, and an attempt to further the program by drawing together and making available, in summary form, a list of the activities engaged in during the past years, publications issued, and services that the committee is willing to perform for interested individuals.

Less than 6 years ago municipal accounting represented the uncoordinated ideas of numerous individuals. Today, a generally accepted body of principles exists, as a result of the activities of the Committee. In 1932, the Municipal Finance Officers' Association began a series of steps looking toward the organization of a representative committee "to formulate principles of municipal accounting, to develop standard classifications and terminology for municipal reports, to consider principles which should be followed in making municipal audits, and to promote the recognition and use of these standards." In 1934, the National Committee on Municipal Accounting was formally instituted. Nine organizations appointed advisory committees on municipal accounting—American Accounting Association, American Institute of Accountants, American Municipal Association, American Society of Certified Public Accountants (now merged with the American Institute of Accountants), International City Managers' Association, Municipal Finance Officers' Association, National Association of Cost Accountants, National Association of State Auditors, Comptrollers and Treasurers, and the National Municipal League, together with a Federal government representative acting in a liaison capacity—, and the chairmen of these committees were organized into the National Committee on Municipal Accounting.

A series of bulletins were then drafted and issued from time to time in order to establish an organized, available, and generally-agreed-upon body of knowledge in the field of municipal accounting. The first publication, a *Statement of Municipal Accounting Principles*, appeared in 1934. This was followed by a *Tentative Outline of a Suggested Procedure for a Detailed Municipal Audit*, and a *Bibliography of Municipal Accounting* in May of the same year. *Municipal Accounting Terminology for State, Municipal and Other Local Governments; Municipal Funds and Their Balance Sheets; Municipal Accounting Statements;* a *Standard Classification of Municipal Revenues and Expenditures;* and various revisions of these publications, which may be obtained from the National Committee on Municipal Accounting at 1313 East 60th Street, Chicago, Illinois, have appeared since 1934.

With the issuance of these publications, the first part of the program has been completed; there now exists an organized and available body of knowledge in the field of municipal accounting. The major emphasis in the future will be on attempts to get practitioners to accept the Committee's recommendations and to place these recommendations into practice. More than 12,000 copies of the Committee's publications have already been distributed and hundreds of inquiries from public officials and professional accountants answered fully and promptly. Public reports frequently contain statements that they have been prepared in accordance with the Committee's recommendations, and many have been submitted to the Committee's staff for study and suggested improvements. In all cases the staff has been ready to make studies and confidential recommendations to the persons submitting the reports.

Many colleges and universities have recently added courses in municipal and governmental accounting and used the Committee's publications. The number of courses given by universities and colleges in the field of governmental accounting has increased from 15 in 1931 to 50 in 1939. The subject now occupies a prominent place in the examinations given for CPA certificates.

The National Committee has left to others the formulation of accounting procedures, but it holds itself ready to advise with individuals or groups who prepare such manuals. And the number of manuals being prepared "in accord with the principles laid down by the National Committee on Municipal Accounting" is beginning to snowball. Particularly fine work has been done in this field by organizations such as the Uniform Accounting Committee of the League of California Municipalities which in 1933 decided "to integrate its work with the work of the National Committee, adopting the principles established by the National Committee in so far as they could be adopted to the conditions and requirements of California municipalities." This work has been repeated in several other states. The principles formulated by the National Committee have also spilled over into other fields of government through the liaison maintained with other organizations such as the Public Administration Service. The Committee solicits opportunities to aid public bodies in preparing legislation to assist public officials and professional accountants who are concerned with municipal and governmental accounting.

The one thing lacking, now, is a thorough and well-organized textbook which will utilize the formulations of the Committee.

It can be safely said that the most rapid strides that have been made in the last decade in accounting, have been made in the field of government, and the progress that will be projected over the future will be even greater. Governmental accounting's older sisters, industrial and commercial accounting, can learn some lessons here in coöperation, effective work, and genuine progress. Public accounting practitioners and theorists have struggled for years to formulate an acceptable body of principles, but with no real success. Despite the fact that the auditor's certificate on corporate balance sheets contains the obeisance "in conformity with generally accepted accounting principles," it has never been possible to formulate such a body of principles in the field of commercial or industrial accounting.

William Cooper

Tennessee Valley Authority

Government and Business. New Second Edition. Ford P. Hall. (New York: McGraw-Hill, 1939. Pp. xii, 444. $4.00.)

This is a new and vastly improved edition of a book first published in 1934 in what was practically an outline form. The vast improvement consists in more lengthy discussions of the subjects of the outline in the previous work; and it has the obvious advantage over any book in this field written in 1934, namely that it was written five years later.

Reviewing any book with such an ambitious title presents peculiar difficulties, and one can do justice to the effort only by projecting it against the background of the difficulties inherent in the task attempted. The confused state of literature and learning in the field of relations between government and business is but a reflection of the confusion of public and private policy in that field. As Professor Hall points out in his Preface, government control of business has received a piecemeal treatment in academic courses in economics and political science. We have courses in public utilities, money and banking, insurance, transportation, taxation, regulation, and so forth. We have monographs galore on some of the legal, economic, social, psychological, historical, and political aspects of the regulation of business. The results have all too frequently been reminiscent of the old Eastern tale of the blind men approaching their first elephant, and guided as to its nature only by the sense of touch. Their resulting disagreements concerning the subject of their research, likening the misunderstood pachyderm to everything from a snake to a tree (depending upon their individual points of departure and the thoroughness of their investigations) contain a moral for our present subject. Our philosophers have failed to see all of the subject and to see it whole.

This points to two related needs in the literature of Government and Business: a work attempting to pull together in one place the varieties of controls of a governmental character operating upon business, and one attempting to relate such controls to the whole political process. Professor Hall's book is of the former type. He has written a textbook designed to give students "a comprehensive picture of the field of government control of business" and to offer them "an opportunity to compare and contrast the control exercised over one industry with that exercised over another." The result is a useful book for students or general readers desiring either a rapid and fairly complete (though summary) description of types of regulations and agencies dealing with types of businesses, or a quick and convenient reference thereto. In no sense is it a philosophical and analytical work like that of J. M. Clark's *Social Control of Business*, also a McGraw-Hill publication. Nor was it Hall's intent that it should be. In many ways these two books contain mutually supplementary material.

The strength and the weakness of Hall's book, as it attempts to give a "comprehensive picture" of the growing field of government and business, may be indicated by the order and headings of the twenty-seven chapters. There is a brief and largely descriptive discussion of the politico-economic philosophies of "individualism," "collectivism," and "socialism," followed by a summary of constitutional aspects of control and of "methods of control" and "types of regulation." There follow chapters on railroads, motor busses and trucks, aviation (not water transportation) and public utilities. Banking and insurance are given separate chapters, as are coal, the antitrust laws, the Federal Trade Commission, and packers, stockyards, and commodity futures regulation. Further chapters are devoted to securities; foods and drugs; taxation; bankruptcy; patents, copyrights, and trademarks; and government aid to business. The balance of the book describes government ownership and operation, Federal, state and local. It is noteworthy that there is no discussion of government competition as such, although mention is made of it as a method of control, a "yardstick," with a mere register of the complaint of the carriers and electrical utilities respectively against the allegedly unfair competition of the Inland Waterways Corporation and T.V.A.

It can be seen that the book is fairly "comprehensive," and each chapter has valuable bibliographical references. Whether it is also a "picture" of the field is a matter of definition. It certainly is neither a motion picture nor a portrait, lacking the dynamic and analytical characteristics, respectively, of each. It more resembles a snapshot. It is thus not a book for one interested in regulation or control as part of the political process in which we all participate. Such a book would be more "personalized." It would show the variety of controls operating in fact, not merely those imposed to carry out logically-defined policy: for not only is there many a slip 'twixt the cup of policy and the lip of performance—there is also considerable divergence between the conception and execution of policy by public officials and the intentions of the sponsors on the one hand and how regulation affects the regulated interests on the other.

These are matters which both public and private business administrators want to know, and this book will not give it to them. It is only fair to state that it doesn't try. There is no discussion of the problem of representation of business interests in a democracy, of the relations of pressure groups and political parties to the problems of government and business, nor of the close relationship, from an evolutionary standpoint, of government aid to business and government regulation of business. The profound implications of increasing public control of accounting receive only a passing mention.

In a word, granting the obvious usefulness of Hall's book in a field characterized by a plethora of monographs and a paucity of even fairly comprehensive works, it still leaves much to be desired. With full appreciation of the difficulties of selection, classification, and presentation of the materials related to government and business, the reviewer feels some *rationale* is better than none, however incomplete or otherwise faulty. For the failure to rationalize and synthesize the materials of regulation results in a mere listing, however useful as such. This conclusion rests on the review-

er's premise, quite subject to criticism, that a bad philosophy of regulation is better than none: it stimulates class discussions, acts as an incentive to cerebration, and may lead to that clarification of objectives and obstacles to their achievement so necessary to the guidace of public policy in this most important field.

J. HAROLD DENIKE

University of Cincinnati

Practical Bank Credit. Herbert V. Prochnow and Roy A. Foulke. (New York: Prentice Hall, Inc. 1939. Pp. xii, 690. $7.50.)

The authors are well equipped for this work by their experience. One is an officer of a large bank in Chicago; the other is an officer in a credit agency. Their reading has covered the historical background. As a result we have the best book on the subject which has come to the knowledge of this reader. It is an excellent reference book for a loaning officer or credit-analyst, and it is excellent reading for young graduates of the American Institute of Banking.

Even so large a book cannot cover thoroughly the entire field of bank-credit. Here the emphasis has been given to unsecured bank loans to domestic clients. This is a wise selection, and in this restricted field the material is well chosen. There are specimen forms used by banks; a specimen credit file; and numerous examples of bank loans, with careful discussion. As is the vogue, much attention is paid to ratios: for example, on page 232 is the remark that 14 ratios "should invariably be made in the internal analysis." Doubtless the authors would agree that while ratios are helpful, the final yes or no on a bank loan usually does not require all 14, and occasionally but rarely is quite independent of ratios.

Quite properly, as I think, the discussion is less complete on collateral loans, mortgages, commercial letters of credit and bankers' acceptances. On these subjects the student or bank officer will find other sources necessary. The present volume merely mentions the fundamentals of each. I think the authors have wisely restricted their book to the present scope, even though it has meant no discussion at all of the market for bankers' acceptances, here and abroad; or analysis of credit reports on foreign commercial houses; or analysis of published statements by domestic and foreign banks. The field of the book is limited to credit extension by the domestic credit department of a bank.

Recent developments have received attention: for example, mortgages under Federal Housing Administration plan; assigned accounts; instalment loans. As a result the book is up-to-date in material as well as in presentation.

W. GRANVILLE MEADER

Industrial Trust Company
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Secretarial Accounting. J. F. Sherwood and Clem Boling. (Cincinnati: South-Western Publishing Company, 1939. Pp. 452.)

As is suggested by the title, *Secretarial Accounting,* this book develops the fundamental principles of bookkeeping and accounting in a style especially suitable for stenographic and secretarial students. It is this reviewer's opinion that the authors have done an excellent job in both writing and arranging a textbook designed to meet the needs of secretarial training institutions. It is necessary to recognize that both the selection of materials and the order and style of presentation of such a text must differ in many respects from the elementary college accounting text. The latter is designed to present basic accounting principles for students preparing for the accounting profession while the former deals with the bookkeeping principles and problems involved in ordinary secretarial positions.

Part I of the book covers the bookkeeping cycle for non-mercantile enterprises with special emphasis on the cash basis of accounting. The equation approach is introduced in the first unit after the necessary elementary terms have been explained. Accounts of professional men are used for illustrative purposes. The profuseness of the illustrations throughout the book unquestionably affords the student of secretarial accounting an adequate survey of bookkeeping forms and each illustration is accompanied by a clearly phrased explanation. (See pages 77–97.) The chapters on bank and insurance transactions are deserving of favorable comment. Twenty-two pages have been devoted to the description of cash and bank transactions and a similar space has been given to the analysis of insurance accounts. The discussion of life insurance includes the recording of payments of policies having cash surrender value and methods used in recording dividends on life insurance. The frequency with which these items are likely to occur in non-mercantile enterprises certainly merits the type of detailed explanation given in this book.

Part II is devoted mainly to the development of the accrual basis of accounting for mercantile or trading enterprises and is probably complete enough to acquaint the student with the fundamental bookkeeping principles involved in this type of enterprise. A brief treatment of capital and revenue expenditures would have greatly strengthened this section of the book. While it is true that the book was not designed as a basic text for those preparing for the accounting profession and as a result a substantial amount of theory was justly eliminated, it should have been kept in mind that it is essential that the secretary be able to record capital and revenue expenditures properly. Federal income taxes are mentioned in Part II but the discussion is so brief that it might well have been completely omitted. This is not a criticism of the book but rather an observation that might be made of any elementary accounting text. Any attempt to deal with income taxes in a basic text will necessarily limit the life of the book since constant revision would be required to keep the book up-to-date with the ever-changing tax laws. Students majoring in accounting will usually be given a complete course in Federal tax accounting and secretarial students should have the option of taking such work, but it seems inadvisable in either case to offer only a smattering of such material in the basic text. It

requires more than a brief discussion in an elementary text to train the student to fill out Form 1040.

In summary it might be said that Messrs. Sherwood and Boling have written an excellent text for the specific field for which it was intended, namely that of secretarial accounting. They have developed in an unusually interesting fashion the bookkeeping principles likely to be used by the secretary. The use of such specific non-mercantile enterprises as law, medicine, and others as illustrations, should act both to maintain student interest and to broaden the student's knowledge of accounting for enterprises deriving their income chiefly from fees for personal service. Frankly, no other book has been brought to the attention of the reviewer that so satisfactorily meets the needs of secretarial training institutions as does this volume.

HERBERT J. CUMMINGS

University of Pittsburgh

Theory of Numerical Roots. Charles E. Tumminello. (Boston: The Christopher Publishing House, 1939. Pp. ix, 178, $2.35.)

It is well known that the arithmetical method of extraction of integral roots is based upon the expansion of the binominal theorem. Thus the underlying theory for the rule of the extraction of square roots depends upon the expansion of $(a+b)^2$; for cube root it depends upon the expansion of $(a+b)^3$, and so on. The book under review may be regarded as consisting of two parts. The first sixty-three pages give numerous examples which have been worked out from the square root to the seventh root, inclusive; the remainder of the book consists of applications of the method to examples. The examples selected often involve roots higher than the seventh, but they are so chosen that the problems can be solved by products of the roots already obtained. The labor involved for computing roots which are prime numbers, such as the thirteenth, seventeenth, and twenty-ninth roots, becomes extremely laborious. Pages 64 through 99 show computations for finding the rate of interest in problems of compound amount. In these cases the invested principal and the final amount are known, as well as the number of years the compounding is to run. The second problem is that of the compound interest rate method of computing depreciation. Here the determination of the rate involves taking of a root when the original value, the scrap value, and the number of years for the investment are known. The remainder of the book, with the exception of the last problem, presents examples in which the edge of a cube is computed when a number of the cubes are piled up in certain special ways. The unit blocks in one set of examples are presumed to be piled to form a large cube whose side is equal in length to the square of the side of one of the small building blocks. The author is willing apparently to have fractional blocks on one side and on the top or bottom. In some of the other examples the unit blocks are laid out upon a square and in still another example rectangular blocks are presumed to have been taken from a stone quarry. The final example might well be listed in a book of mathematical curiosities, for it illustrates the well-known fact that high roots of even large numbers tend to have a value approaching unity when the root increases, while roots of very small numbers less than one tend to increase, approaching unity as the root increases.

From a practical point of view, which apparently is the objective of the book judging from the preface, one wonders what real help such procedures will give an accountant or possibly a statistician. Certainly, in the mathematics of finance the material is applicable to only two cases out of the great number of problems which might be stated involving compound interest, amortization and depreciation, and life insurance. From the point of view of a test for reference for those who might be designing new methods of adapting calculating machines to accounting procedures the outlines might be helpful, since certain methods of taking square and cube roots on computing machines depend upon the mathematical principles used in this book. One wonders, also, whether the large number of problems worked out with "cubical (alphabet) toy blocks" are not incidental when one considers the many types of computations which must be carried through in everyday business transactions.

In typography and arrangement the book is well put together. The examples are easy to follow and with one minor exception are easy to locate. It is to be wished, however, that a table of contents had been included.

THEODORE H. BROWN

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Accountancy as a Career. Lawrence W. Scudder. (New York: Funk & Wagnalls Company, 1939. Pp. viii, 161. $1.50.)

This little book contains the following chapters:

I. Qualifications of an Accountant
II. Rise and Development of Accountancy
III. What the Public Accountant Does
IV. The Profession of Accountancy
V. Accountancy as a Stepping Stone
VI. Preparation for Accountancy
VII. Romance of Modern Business
VIII. Detecting Defalcations, and Other Tales
IX. The Trials and Tribulations of a Young Accountant
X. The Future of Accountancy

The chapters are written in a simple, easy, readable style. From them it is clearly evident that the author is a human being with an abundant sense of humor. Several good and practical stories keep the reader's interest alive.

Although the attractions of Accountancy as a career are stressed adequately, its darker sides are also given well-deserved attention. The book, which can easily be read in a couple of hours, should do much to acquaint young persons with the possibilities open to them in the accounting profession. It is the sort of book which should be found in all libraries frequented by young people.

ARTHUR W. HANSON

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Applied General Statistics. Frederick E. Croxton and Dudley J. Cowden. (New York: Prentice-Hall, Inc., 1939. Pp. xviii, 957. $4.00.)

In 1934 Professors Croxton and Cowden published *Practical Business Statistics,* which has since become one of the most widely used textbooks in the field of business statistics. The present volume is a greatly enlarged edition of the former one and is written from the point of view of the application of statistical methods to various fields, particularly the social sciences. For this reason the examples used for the description of technique are taken from economics and sociology as well as from business. In every instance the illustrations present practical problems that should immediately stimulate the interest of students. Such an approach certainly aids the instructor in showing that statistical methods are tools of research that have very general use.

The arrangement of the book is similar to the 1934 edition. It covers the usual chapters on the collection of data, graphic presentation, the analysis of the frequency distribution, the normal curve, time series analysis, index numbers and correlation. The four chapters that have been added cover in excellent fashion: (1) "Reliability and Significance of Percentages, Standard Deviations, Variances, and the Criterion of Likelihood"; (2) "Other Trend Types" (such as curves of declining absolute growth and asymptotic growth curves); (3) "Types of Seasonal Movements" (including progressive and sudden changes in seasonal, the Easter adjustment and weekly seasonal); and (4) the original chapter on "Types of Correlation" has been expanded into two chapters, one on "Non-Linear Correlation" and one covering "Multiple and Partial Correlation." In each of the twenty-five chapters the methods recently developed have been included. There is, for instance, the method of analyzing time series that Professor Wesley C. Mitchell developed in his study of the business cycle, as well as the distribution of lag suggested by Professor Irving Fisher. For the benefit of those instructors who might consider some of this technique too advanced for their classes, or more than can be covered in the allotted time, the authors have indicated certain chapters and parts of chapters which may be omitted without loss of continuity. The teacher also will find the many references, and summaries of the material covered in the references, which follow each chapter, of considerable value.

The appendices are 18 in number, requiring 120 pages. In addition to the usual appendices showing tables of ordinates and areas of the normal curve, chi-square, squares, roots, reciprocals, and logarithms, some of the others include: (1) A list of source material which is short but carefully selected; (2) A mathematical appendix giving the derivation of the formulae used in each chapter (a great time saver for the instructor); (3) Tables of the values of t and z; (4) A "Flexible Calendar of Working Days, 1898–1950"; and (5) A "Glossary of Symbols and Formulae" of the more important symbols and formulae used in the book. The latter should help those students who become confused by the different uses of the same symbols in statistical methods.

While the authors of this volume have included a vast amount of statistical technique as is evidenced by the number of pages, more than 800 not including the appendices, they have presented it in a very lucid and interesting manner, a feat that has not been accomplished often in this field. Undoubtedly the book ranks with the best that have been published to date.

Accompanying *Applied General Statistics* is a *Workbook in Applied General Statistics* by Professor Croxton which contains problem material and various forms for the solution of the problems.

RAYMOND F. BLACKBURN
Associate Professor of Statistics
University of Pittsburgh

Federal Income Tax Accounting Stewart Y. McMullen. (New York: The Ronald Press Company, 1939. Pp. xvii, 315. $5.)

"A practical course for basic instruction" is the brief description carried by the title page of this book. It would be difficult to phrase a more accurate one. The volume is designed to serve as a text for a thirty hour course in elementary income tax accounting. The introduction of tax return Form 1040A on page three is indicative of the emphasis on the practical aspects of the subject. Such topics as reorganizations, corporate dissolution, depletion, personal holding companies, installment basis of reporting income, and penalty provisions are omitted entirely or dismissed with very brief comment. In fact, the subject matter is strictly limited to material which is considered basic.

The chapter titles are as follows: Form 1040A; Form 1040; Joint Returns; Basis and Capital Gains and Losses; Basis and Tax-Free Exchanges; Corporation Income and Excess-Profits Tax Return, Form 1120A; Corporations with Net Incomes of $25,000 or Less; Federal Income Tax on Corporations with Net Incomes of More Than $25,000; Federal Corporation Excess-Profits and Capital Stock Taxes; Losses and Bad Debts; Depreciation and Inventories; Partnerships; Estates and Trusts; Federal Income Tax Entities; Examinations, Appeals, and Refunds.

Each of the fourteen chapters includes problems and questions with solutions and answers. It is worthy of note that the distinction between problems and questions is a very real one. The problems are not merely cases or questions as has been true in some of the texts in this field.

The material is prepared in loose leaf form with the sheets of each chapter held together by a single staple. The solutions to the problems and the answers to the questions do not accompany the chapter to which they relate. Instead, they are stapled with the pages of a subsequent chapter. This arrangement facilitates the distribution of the printed solutions after the student has worked out the problems.

The manner of presenting the material differs from that used by most of the other texts in this field. Tax return forms receive more than the usual amount of attention. A number of chapters are devoted to item-by-item discussions of this subject. The preparation of the tax return in a specific instance provides the central theme for each of these chapters.

The use of specific cases characterizes the work throughout. There are forty-one such cases in one chapter. Even in those chapters which are organized around the case of a certain taxpayer, the discussion is supplemented by the introduction of other short cases. In this way, the author sets forth differences in circumstances which have a bearing on tax liability. Such matters as the constructive receipt of income, the taxability of dividends received, losses as allowable deductions, and credits against income are covered by illustrative cases of this sort.

The material does not include reprints of the law or regulations. Many direct quotations from these sources appear but these are short, usually not more than one or two lines. There are numerous parenthetical references to the law. References to decisions and rulings of the Board of Tax Appeals, the courts and administrative bodies are also frequent and appear as footnotes.

The author sets forth a generally accepted interpretation of the law and regulations and his style is very direct and easy to understand. There may be some who will feel that the scope of the text is too limited for even an elementary work. It is the organization of the subject matter that will meet with criticism. Objections will be made on the ground that the subject matter has not been presented in a logical fashion in that the basic concepts of gross income, allowable deductions, credits against income and credits against tax have been subordinated to item-by-item discussion of certain tax returns.

Regardless of differences of opinion which might exist regarding the most satisfactory organization of material in the elementary income tax course, it seems reasonable to expect that the text will accomplish the objectives that the author set up for himself. It was his intention that the course train the student to "(a) prepare the commonly used forms, (b) recognize a tax problem, (c) use the available sources of information, and (d) recognize when to refer difficult matters to a professional tax practitioner."

W. E. Dickerson

Ohio State University

Business Arithmetic for College Students. William S. Schlauch. (New York: F. S. Crofts and Company, 1939. Pp. 265. $2.80.)

In order to give the student a better understanding of the meaning and use of the numbers with which he deals, this new text begins with an elementary discussion of the formation of the number system, including brief mention of complex numbers. Approximately one-hundred pages are devoted to a thorough review of the fundamental processes of arithmetic. All of the usual topics, in addition to short chapters on statistical and the metric system, are included. The exercises are numerous and well chosen.

The remainder of the text is devoted to discussion of specific types of business problems, including chain discounts, mark-up and mark-down, simple interest, bank discount and partial payments, depreciation, compound interest, stocks and bonds, amortization and sinking-fund methods of refunding obligations, instalment contracts, equation of accounts, and the transmission of funds.

The method of solution of all problems throughout the text is non-algebraic, and the average high school or business college student should have no difficulty in following the numerous examples worked out in detail. The intention of the author has evidently been to reduce to an absolute minimum the number of formulae included. The few formulae used are obtained from examples, by analogy, and presuppose no knowledge of algebra. Because of the elementary nature of the text and its rather limited coverage, the reviewer does not believe this text should be used in college courses in schools of business administration.

A well-written chapter on the transmission of funds, as exemplified in domestic and foreign exchange, is included. For those high school and business college students going directly into business, there would perhaps be no other opportunity to study the foreign exchange as applied to importing and exporting. The inclusion of this material here is a decided improvement over most texts of this type.

The method of development of certain formulae, notably those for the amount and present value of an ordinary annuity, is so crude that the reviewer feels it would have been better merely to have stated these formulae without "proof." The author does not use the term "annuity," and fails to mention that his "sinking-fund plan" and "amortization plan" are special cases of this more general class of functions. It is felt, too, that, even in elementary texts of this type, the student should not be left with the impression that periodic rent payments must coincide with interest conversion dates.

The text is, on the whole, well written, and one which should find wide acceptance for the student desiring to develop mechanical proficiency in the solution of the more common types of business problems.

R. A. Purviance

University of Tennessee

Practical Budget Procedure. John H. MacDonald. (Prentice-Hall: New York, N. Y., 1939, pp. 326.)

This book merits careful reading not only by accounting executives, but also by teachers of budgetary and accounting control. The author is thoroughly familiar with current budgetary practices, and is himself the budget officer of a large business, the National Broadcasting Company. The book covers both principles and methods, with primary emphasis on procedure. "In each chapter the principles involved are first fully covered, after which the methods followed by well-known companies are described specifically and in sufficient detail to illustrate adequately the practical application of the point under discussion." It is well written, and easy to read, not only because of its simple and clear diction, but also because of the numerous illustrative cases drawn from many different kinds of businesses.

Although it will probably not be used extensively as a classroom text, many teachers will undoubtedly recommend it to their students for supplementary reading or reference.

The major portion of the book (all Chapters except the last) deals with procedures of budget *preparation*.

To begin with, the reader is given a few definitions and a brief description of general matters such as prerequisites of successful budgeting, relation to accounting, length of the budget period, and organization for budgetary control. Then in chapters two and three, sales forecasts and sales budgets are described and adequately illustrated, cyclical and seasonal influences are emphasized. The factors underlying sales budgeting are analyzed, and various methods of coördinating the sales estimates with production capacity and financial resources are illustrated by the citation of numerous cases.

Special consideration is given in Chapter IV to the procedure of preparing the budget of Selling Expenses, especially the Advertising Budget. The basic distinction between fixed and variable expenses is strongly emphasized. The desirability of applying cost accounting methods to the standardization of selling expenses is also approved and endorsed.

In Chapters V to XI, the author discusses the various parts of the manufacturing budget such as the production schedule, inventory materials and purchase budgets, the direct labor budget and the manufacturing expense budget. Several excellent illustrations are given of manufacturing expense budgets taken from large companies.

The author makes timely comments upon the difficult problem of preparing the maintenance expense budget. To many manufacturers this problem seems to be incapable of solution. Mr. MacDonald very wisely supports his suggestions with an illustrative case, in which the maintenance expenses are being successfully controlled by proper methods of budgeting.

Following the discussion of the various parts of a manufacturing budget, the author takes up in Chapters X and XI, the budgets of merchandising business such as wholesale houses, department stores and branch stores.

In Chapter XII the budget of capital expenditures is explained. Cases are cited both from utility and industrial fields, of budget procedures that are being followed, in the control of fixed assets.

In Chapters XIII and XIV, the author outlines the procedures for setting up the cash budget and the master budget. The cash budget differs from all the other budgets in that it includes only cash actually received and cash actually to be disbursed. The author makes this clear by saying "depreciation is not a cash item and thus is ignored entirely in preparing the cash budget. On the other hand, new plant and equipment paid for in a single year or budget period are included in full in the cash budget, whereas none, or at most only a part of their costs is charged to operations through the depreciation account in the same period."

The master budget, according to the author, includes "an estimated profit and loss statement, an estimated balance sheet, a cash budget of capital expenditures." At this point Mr. MacDonald presents the master budget of his own company, the National Broadcasting Company. He indicates the need for a master budget, and its importance to the chief executives of a business.

In Chapter XV, three kinds of budget manuals are described and illustrated: "First, there is the manual which is designed primarily to explain budget policies and methods specifically but does not go into detail... Second, there is the budget manual which covers the entire budget procedure in considerable detail with illustrative forms... Third, there is the budget manual which, while it is very specific and makes considerable use of forms, is prepared primarily for distributors in budgeting their operations." The three manual types are illustrated by a partial reproduction of the Thomas A. Edison, Inc. manual, the McGraw-Hill Publishing Company, Inc. manual, and Iron Fireman Manufacturing Company manual, respectively.

In the final chapter of the book, the author suggests various methods of making the budget work. He offers three basic questions, namely, "When should summary comparisons be used; when are more detailed comparisons desirable, and to what extent should department heads be asked to explain differences between budgeted and actual results."

The author recognizes the fact that the term "summarized" may mean different things to different executives. In some cases summary reports contain much detailed information, in other cases only grand totals. Therefore, management must make clear what comparisons are to be made, and the degree of detail desired.

Many helpful suggestions are included in this Chapter for executives and accountants who prepare budget reports. The entire book is, in fact, aimed at the management level. Because of the numerous illustrations cited, the book has special value for men who are engaged in the budget work of their businesses. It contains many references to current practices, and in many cases, the author attempts to evaluate the illustrated procedures. His criticisms are for the most part, fair and reasonable.

The author may be criticized, however, by some for including an excess of illustrative cases, quite a number of which are so similar that the reader is unnecessarily detained in his reading. However, in a book of the popular-appeal type, such as this, this criticism loses some of its point, or it may be rightfully shifted from the author to the publisher, who could well have suggested the elimination of some of the excess illustrative material.

The author's conviction that budgetary control is much more clearly related to management than to accounting is interesting, if not wholly convincing. He says briefly in the preface. "A budget, to be sure, seeks to project the future in accounting terms. The accounting aspect, however, is only incidental to the main objective which is to plan the work and then control operations accordingly—an activity which certainly is a function of management rather than of accounting." However, most budgets are being prepared today by *accountants*, who summarize their data from the accounting records, and prepare the budgets in conformity with the ledger classification of accounts, and what is more important, they seriously attempt to avoid any violation of generally accepted accounting principles in the preparation of the budget.

Edwin L. Theiss

University of Illinois

Organization and Management of Production. By William N. Mitchell, Associate Dean of the School of Business, University of Chicago. (Business and Economic Publications, William Homer Spencer, Editor). (New York: McGraw-Hill Book Co., Inc., 1939, 417 pages, $4.00.)

While there are already many excellent texts on Industrial Management and five or six new ones either just published or announced for the school year 1939–40, this text will be welcomed by management teachers in colleges of business administration. It has these singular features:

(1) It is designed primarily for business college students, and unlike many other texts on Industrial Management, does not attempt to highlight those aspects of every other branch of business administration in which managers might be interested. Its content and style assume a background of business training on the part of of the student.

(2) It is adaptable for teaching production management as either part of a special business administration curriculum in management or as a course required of all students.

(3) The appendix, problem material, questions, cases, etc., provide an excellent vehicle for stimulating original thinking on the part of the student and for fixing in his mind the basic principles of production management.

Professor Mitchell demonstrates a thorough acquaintance with both the literature of management and its practical aspects. In reality, his text is a revision and new adaptation of much of the material he originally presented in his "Production Management," published in 1931 by the University of Chicago Press. This has been rearranged, expanded, and combined with several new chapters to produce a book both larger in size and more inclusive of topics of primary concern to production managers. The combination of these features enhances its teachableness and classroom adaptability.

From a pedagogical viewpoint, however, there are several shortcomings. The topic presentations included in the book could be much improved by briefer treatments. Moreover, since many students in business administration have few opportunities to become familiar with the physical features of the industrial plants whose management is under discussion, Professor Mitchell's text is lacking in the proper number and kind of illustrations. These are very helpful to the student whose inability to visualize topics under discussion handicaps his comprehension.

Few texts are perfect from any teacher's point of view, and no text is perfectly suited to every individual teacher's course, but it is the writer's belief that this particular text will be enthusiastically received by many teachers of industrial management in business colleges as being more adaptable to under graduate management teaching than anything that has appeared heretofore.

Asa S. Knowles
College of Business Administration
Northeastern University

Social Security and Pay-Roll Tax Accounting. J. F. Sherwood and John A. Pendery. (Cincinnati: Southwestern Publishing Co., 1939, pp. 256. $2.60.)

This book provides a well-arranged and understandable explanation of the Federal Social Security Law as amended in 1939, together with a comparative outline of the unemployment compensation laws of the various states. The federal unemployment insurance sections are explained and illustrated, but there is no extended discussion of the unemployment insurance laws of any particular state. To make it of practical as well as theoretical value, considerable space is devoted to payroll records, accounting entries and forms for recording the information required under the law. Of particular benefit to employers, the book is also of interest to employees since attention is given to the computation of employees' benefits and those of survivors and dependents, a computation which was complicated by the changes in benefits made by Congress in 1939.

Bound in loose leaf style, the book is developed primarily as a textbook and contains in addition to the explanatory matter, ruled sheets and forms for use of the student. There are ten divisions of the work, designated as lectures, together with appropriate quiz questions and problems. Beginning with a general explanation of the various sections and purposes of the Federal Social Security Act in the first lecture, one quickly encounters in the second lecture the difficulties of computing individual benefits under the old age benefit section. This needs and is given considerable illustration. Following this is a discussion of the taxes levied on employer and employee to furnish the funds to support the plan.

Unemployment compensation is considered next, in lecture four, types of funds, coverage, benefits and contributions are discussed in a general way since, while there is a Federal tax for unemployment, its purpose is to make and keep uniform the various state laws. Since these may all vary in some respects, a comparative table indicates the chief points. The taxes imposed for this purpose follow in order.

Lecture six embraces an explanation of the Railroad Retirement Act, the Carriers' Taxing Act, the Railroad Unemployment Insurance Act and the incidental taxes. Lecture seven, eight, and nine cover the subject of forms, records and accounting, with illustrative cases. The final chapter is a project in which the student is given an excellent opportunity to apply the information developed in the preceding lectures. The work deserves wide recognition as a text in the field of pay-roll taxes.

William Connelly
New York University

UNIVERSITY NOTES

University of Southern California

A successful "Institute of Accounting" was held on the campus during the morning and afternoon of October 26. Those coöperating in making arrangements were the Los Angeles chapters of: California Society of Certified Public Accountants, Controllers Institute, National Association of Cost Accountants, Credit Men's Association, Petroleum Accountants Society. Iota chapter of Beta Alpha Psi also assisted.

Among the speakers were *Mr. J. B. Scholefield*, president of the California Society of Certified Public Accountants; *J. L. Chambers*, Special Assistant on Accounting Systems and Procedures to the Commissioner of Accounts & Deposits, U. S. Treasury Department, Washington, D. C.; *Miner B. Phillipps*, Controller of the City of Pasadena and President of the National Fiscal Officers Association; *Wesley Cunningham*, Treasurer of the General Petroleum Corporation of California; and *George T. Altman*, tax specialist and advisory editor of *Tax Magazine*.

Attendance was in excess of 300.

University of Denver

Upwards of twenty students majoring in accounting were employed by local public accounting firms during the busy season. Three seniors passed the C.P.A. examination of last November.

University of Cincinnati

Professor H. C. Geis recently received the Ohio C.P.A. Certificate.

University of Indiana

Six students to be graduated next June were employed by public accounting firms in Chicago, Indianapolis, and Cincinnati during the busy season. All will have returned to their studies by March 15.

The School of Business will move into its new half million dollar building in the early summer. The new structure provides special accounting rooms, an accounting and statistical machine laboratory, ample library facilities, student lounges, and offices and conference rooms.

University of Missouri

Paul J. Graber, assistant professor of accounting at Oklahoma A. and M. College, will teach in the summer session of 1940. R. D. M. Bauer, associate professor of accounting, was appointed by Governor Stark recently to a five-year membership on the state board of accountancy.

University of Montana

Plans are being made to offer accounting instruction in the summer school beginning with the 1940 session.

Northwestern University

The following advancements in rank occurred in 1939: from associate professor to professor: E. C. Davies and C. M. Gillespie; from instructor to assistant professor: H. D. Kerrigan and S. W. Specthrie.

An accounting clinic is being planned for the end of April. Present intention is to hold an all-day meeting in the Palmer House, Chicago, with "annual reports" serving as the central theme of the morning, afternoon, and evening sessions. The Illinois Society of Certified Public Accountants is co-sponsor of the meeting. The society's special committee on arrangements consists of the following men: Fred J. Duncombe, Chairman, Walter Le Clear, Jackson Smart, Carman Blough, Robert C. Brown (ex officio), Albert Simon, and David Himmelblau. Speakers secured for the meeting will represent accounting, law, and business.

University of Texas

F. F. Tannery is making an investigation of various state systems of procedure for the National Association of State Auditors, Comptrollers, and Treasurers.

University of Washington

Donald H. Mackenzie, professor of accounting and management, has joined the faculty of the Harvard Graduate School of Business Administration for the second semester. Wendell Trumbull of the University of Michigan is taking over Professor Mackenzie's classes during his absence. Professor Homer E. Gregory is the author of a study entitled "Pacific Northwest Fisheries," which was recently published by the Institute of Pacific Relations. James McConahey, chairman of the department of accounting, was elected a member of the grand council of Beta Alpha Psi at the last annual meeting held in December in Philadelphia. Seven of the fifteen successful candidates at the November, 1939 C.P.A. examination were graduates of the University of Washington.

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